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IRS PENALTY REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT
PLANS AND OVERSIGHT OF THE
INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

SEPTEMBER 28, 1988

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IRS PENALTY REFORM

WEDNESDAY, SEPTEMBER 28, 1988

U.S. SENATE,
SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND
OVERSIGHT OF THE INTERNAL REVENUE SERVICE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:30 a.m. in Room SD-215, Dirksen Senate Office Building, Hon. David Pryor (chairman of the subcommittee) presiding.

Present: Senators Pryor and Heinz.

[The press release announcing the hearing follows:]

[Press Release No. H-38, September 20, 1988]

PRYOR SUBCOMMITTEE TO HOLD HEARING ON IRS PENALTY REFORM

WASHINGTON, DC—Senator David Pryor, (D., Arkansas), Chairman of the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, announced Tuesday that the Subcommittee will hold the second in a series of hearings to examine the Internal Revenue Code penalty structure.

The hearing is scheduled for *Wednesday, September 28, 1988 at 9:30 a.m.* in Room SD-215 of the Dirksen Senate Office Building.

"Many taxpayers, especially small businesses, are being hurt by the present tax penalty system despite making good faith efforts to comply. Congress has a great interest in ensuring that there is a penalty structure that encourages compliance, not one that causes people to lose faith in the fairness of the collection system," PRYOR said.

"In this hearing, various groups will discuss specific problems they are having in the tax penalty area. The Subcommittee will also receive testimony from industries interested in information reporting requirements," said Pryor. "It is my hope that the Subcommittee will be able to establish a useful record on the issue of penalty reform."

OPENING STATEMENT OF HON. DAVID PRYOR, A U.S. SENATOR FROM ARKANSAS

Senator **PRYOR**. Good morning. The subcommittee will come to order. We appreciate having not only our witnesses today but also our audience who is expressing, I think, keen interest in this issue of penalties of the Internal Revenue Service.

This, as you know, is the second of three hearings before this subcommittee to review the penalties of the Internal Revenue Code. In 1975, the Administrative Conference of the United States called the 64 penalties of the Code"mind numbing." Thirteen years have gone by, and that mind numbing array of civil penalties of 64 has now grown to over 150. It is a morass of inconsistency and irrationality that often discourages rather than encourages compliance in our tax system.

These hearings this morning have been called to receive comments from the public on what the Congress might do to clean up this mess, and it is a mess. From the testimony of the first hearing, a number of key issues seem to be rising to the top. The overwhelming response has been a concern that small businessmen and women often bear the brunt of the present system.

This subcommittee will be particularly concerned in finding ways to relieve this burden. I look forward to receiving testimony from small business groups today.

Additionally, the present system suffers from numerous structural inadequacies. It punishes the barely compliant as severely as the professional tax cheat. Taxpayers often find themselves with huge obligations as a result of the IRS' ability to pyramid the penalties within the Code. Punishment is often harshest for those taxpayers who attempt to correct their own filing errors.

Companies, which must file information returns on third parties, find themselves facing large penalties for noncompliance, even though they are today in many cases making a good faith effort to comply.

Congress must also consider the fairness of the present substantial understatement penalty. We must explore whether it is fair to penalize taxpayers strictly for failure to comply without proving intent on the part of the taxpayer.

Also, we must consider the role of penalties in raising revenues for the Federal deficit.

Finally, there is a very serious question of whether or not the IRS is administering the present penalty structure judiciously and properly. From the testimony that we will hear this morning, it seems the IRS lacks a consistent policy of implementation, resulting in significant regional differences.

In addition, the IRS places a low priority on collecting data necessary in the administration of those penalties. To use an analogy, I would find it very difficult to believe that a major U.S. company would manage a comparable program so vital to its business mission without essential data collection to analyze the success and failure of the program.

Once again, I would like to thank the witnesses today. Some months ago, I appointed a penalty task force of some 22 individuals from across our country, representing a cross section of American taxpayers.

Some of our witnesses today are from that task force. They have meet on two occasions. They have divided up into subcommittees, and they have taken their charge very seriously. They have devoted themselves, their own resources, their own time, their own money to carrying out the mandate for this particular task force.

I want each of them to know how much I appreciate their being here.

Ms. Jennie S. Stathis, Associate Director for Tax Policy and Administration of the General Accounting Office, the General Government Division, will be our first witness this morning.

I will impose this morning the 5-minute rule. We have some nine witnesses; we have four panels. So, I will impose the 5-minute rule, and there will be questions from the committee to each of the witnesses this morning. There may be further questions in writing from other members of the committee.

We are very fortunate today—I have just noted—to welcome Senator John Heinz of Pennsylvania, who is a member of the Finance Committee and a member of this subcommittee. Senator Heinz?

OPENING STATEMENT OF HON. JOHN HEINZ, A U.S. SENATOR FROM PENNSYLVANIA

Senator **Heinz**. Mr. Chairman, first I want to commend you for holding this very timely hearing. My remarks this morning will be brief.

I just want to say that our tax laws have always been based on voluntary compliance; and to encourage voluntary compliance, lawmakers have always included penalties for the taxpayer who didn't want to voluntarily comply. The negligence and fraud penalties were originally enacted as part of the Revenue Act of 1918, and these penalties are still with us today.

However, we now have, since 1918, accumulated a total of some 150 different penalties; and as income tax laws have increased in scope and complexity over that same period, so, too, has the complexity of the penalties. In 1975, when there were 64 penalties, in less than 13 years between then and now, that number has more than doubled to the figure I gave a moment ago. Many of those penalties were included to discourage certain behavior, such as the tax shelter penalties, while others were added as a means of raising revenue, rather than to encourage voluntary compliance.

I think one of the questions we have to ask ourselves is whether some of these penalties are promoting or leading to a decline in the level of voluntary compliance.

I will give you one example, if I may: The recently passed House Technical Corrections Bill contains a provision which will increase the bad check penalty. If enacted, it would increase that fee which now exists, from $5 to the greater of either $15 or 5 percent of the amount owed.

Now, I have no problem with increasing the fee from $5 to $15 since the penalty should cover the administrative costs. Garfinckel's or Safeway would charge you about the same amount. However, putting the fee if you will on a contingency basis, 5 percent of the amount owed, is actually increasing the failure to pay your tax penalty. Clearly, this measure was added as a revenue raiser and shouldn't be accepted at conference.

So, in sum and substance, I want to congratulate Senator Pryor for noticing what is becoming, I fear, a serious problem for the administration of the Tax Code, for the taxpayers, and for rational tax policy. So, Mr. Chairman, I commend and thank you for holding this hearing.

Senator **Pryor**. Senator Heinz, thank you, and thank you for your attendance and your interest; and we look forward now to hearing from the General Accounting Office. Ms. Stathis?

STATEMENT OF JENNIE S. STATHIS, ASSOCIATE DIRECTOR FOR TAX POLICY AND ADMINISTRATION, GENERAL GOVERNMENT DIVISION, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Ms. STATHIS. Good morning. We are pleased to be here this morning to assist in your continuing review of civil penalties. I would like to introduce my colleagues. To my left is Lynda Willis, our group director who is responsible for this area and several others. To my right is Tom Wolters from our Kansas City Regional Office, who is responsible for this particular project.

As you know, we are doing a penalty review at your request and that of Chairman Pickle of the House Ways and Means Oversight Subcommittee. The combined workload from your two requests is that we will be reviewing 11 key penalties. We are also looking at the IRS study of civil penalties at your request.

Our work is continuing; it is not complete. Therefore, our remarks today should be considered as preliminary.

I will summarize my testimony and present the statement for the record. As both you and Senator Heinz have alluded, we do have a lot of penalties today that have been added to the Code over 70-some years for various purposes; and as a result of the ad hoc way they were added, it has been some time since we have looked at the overall structure.

In fiscal year 1987, IRS reportedly assessed almost 27 million penalties, totalling $14 billion. And with the greater use of such penalties, it is understandable that more questions are being asked today about the role that penalties should play in our tax system.

Like other aspects of tax administration, taxpayers can encounter many different penalty situations, not only because of the large number of them, but because the administration is so decentralized. There can be literally thousands of IRS employees all around the country who are involved in assessing these penalties.

From that information alone, you know that IRS has a great challenge in trying to put in place the administrative procedures to ensure that taxpayers are treated consistently around the country.

The potential for inconsistency is exacerbated by the complexity of the assessment and abatement process, and we think the potential for inconsistency is also exacerbated by the fact that there is so little information available about what is actually occurring out there.

We continue to have concerns about the data that IRS managers have available to them to help in this effort. The data systems currently do not provide such basic information as how many of these penalties are assessed and abated.

We have in our statement a few excerpts from some past work that we have done on individual penalties and that the IRS internal audit staff has done on individual penalties showing some evidence of past administrative problems. Those are sort of a prelude to the work we are doing now. We know from some of those reports that there are cases where penalties were not assessed where they should have been, where they were not computed accurately, and where district offices' policies varied.

The last part of our statement covers the IRS penalty study. We believe that it is a good first step in looking at the penalty situation, and we believe the study will be useful in reaching a consensus on the definition and role that civil penalties should play.

We continue to have some reservations about the usefulness of the study in that it will lack a lot of empirical data from which you will know to what extent these problems exist, and it will be lacking somewhat in the causes of these problems and therefore make it more difficult to reach specific recommendations about what to do.

We are somewhat tentative in the statements that I am making about the IRS study until we see the resulting product. We might have different conclusions once we see it.

We do believe that, once we do the review that you and Chairman Pickle have asked for, we will have more information on the 11 penalties that we are looking at; but understanding that those are only 11 of the 150, we still won't have complete information on the administration of all the penalties.

We do plan to do some analyses ourselves of the IRS data base, and hopefully that will be useful as well.

I will conclude my statement with that and say that we will be pleased to respond to your questions.

[The prepared statement of Ms. Stathis appears in the appendix.]

Senator PRYOR. Ms. Stathis, we appreciate your coming this morning and for the report that GAO is doing, subject to the request of Congressman Pickle and myself. We are deeply indebted to you.

When will the final report be available for us?

Ms. STATHIS. Oh, that is a tough question. The data situation is so severe that we don't yet have a sample of penalties to review or know how large of a sample we are going to have to look at. Thus, it is very difficult to project for you; but I would not expect a product before late next spring at the very earliest.

Senator PRYOR. What about before April 15th?

Ms. STATHIS. Not likely. We may have some preliminary data, but we won't have that report completed by then.

Senator PRYOR. You mentioned in your statement, and I was taken aback when you said, that in 1987, we had a 100 percent increase over 1986 in the dollars collected of penalties; and there was an asterisk there, I believe, saying that this was due to a data base change or something of that nature.

Could you explain that? Did we actually collect more dollars—100 percent more—in 1987 than in 1986?

Ms. STATHIS. I think those were assessed penalties, rather than collections.

Senator PRYOR. So, we assessed more penalties against the taxpayer, amounting to a 100 percent increase, in 1987 over 1986?

Ms. STATHIS. Yes, but the footnote—the asterisk—was to forewarn people that this may not be as real as it seems. The data base shows that information; but we know that some penalties that have always been assessed were not in the data base before but were added in 1987.

So, that causes the numbers to be somewhat inconsistent.

Senator PRYOR. Thus far in compiling information for the report to Congress, are you finding inconsistency from IRS region to region? Do the same penalties apply, say, in the area of Arkansas where I live and to the area of Pennsylvania where Senator Heinz lives? Are we finding inconsistent applications?

Ms. STATHIS. Yes, we have some information about that in the testimony. I believe it is on about page 6, where we are talking about the return preparer penalty, and we are demonstrating there that the number of penalties ranged from zero in one district to as many as 341 in another one.

And on the basis of dollars assessed, the variation was even larger. You have one district that had assessed $2.2 million out of the total $4 million assessed on that one penalty. So, there really is some variation among the districts.

Senator PRYOR. All right. Why is this inconsistent application occurring? And what can the IRS and/or the Congress do about it?

Ms. STATHIS. Once we look at our sample of return preparer penalties, I will have a lot firmer conclusion for you; but we know from some past work that districts often come up with their own policies for a particular penalty. They may perceive that they have a particular compliance problem in their district.

So, they take a more assertive attitude about assessing the penalty for some period of time to see if they can enhance compliance. That may not necessarily be bad.

Also, policies vary. I think there is mention in here of an IRS internal audit report where they found that policies varied among the districts. What had happened was that one district would encounter a particular problem in how to assess a penalty or handle a specific situation; and they would come up with their own answer as to how to do it. A district somewhere else in the country encountered the same problem and came up with a different answer.

So, there was no national office policy that was consistent among all the districts. In some cases, internal audit had found that the national office didn't even know that those problems had arisen. So, they had really not had an opportunity to ensure that there was a consistent policy.

Senator PRYOR. If you were shopping around for a region of the country to live in, let's say to escape the wrath of a multitude of penalties, where would you go?

Ms. STATHIS. I have no idea.

Senator PRYOR. Where would you not go?

Ms. STATHIS. It would probably depend on the penalty. We don't yet have enough data to tell you that the same district is the one not assessing any of these penalties. It varies by penalty.

Senator PRYOR. Does the IRS use the same data base that GAO would use, let's say, in coming up with some of these answers and some of these facts and figures that we are being inundated with?

Ms. STATHIS. We all have the same data bases. We have found some inconsistencies among different pieces of information we get.

Senator PRYOR. Now, you are a little bit harsh on the IRS—not harsh—I have been harsh on the IRS from time to time. You say that the IRS Commissioner study on penalties falls short of the comprehensive review needed; I think those are your quotes.

I wonder if you might explain that a little bit?

Ms. STATHIS. I think we are pointing out that the study, to a large extent, seems to be based upon opinion. An opinion might be very good but, when you are assessing 24 million penalties all around the country, you have to get a lot of experts to have enough of them who would know what the total picture looked like.

So, in an area this large, you are really somewhat dependent upon more than just opinion.

Senator PRYOR. Thank you. Senator Heinz?

Senator HEINZ. Mr. Chairman, I have no questions at this time.

Senator PRYOR. Do you think that we are going to see any big surprises in the GAO report?

Ms. STATHIS. I have no idea.

Senator PRYOR. Almost periodically, I meet back home with a group of small public accountants and CPAs who represent really only small business. I am finding a deeper and deeper frustration with this group of people who practice in trying to advise the small business people on how to comply and how to avoid penalties or, if they get behind in their employment taxes on a quarterly basis, how they go about working themselves out of a hole.

They think that the penalty system today is becoming so arbitrary and so harsh and so overburdensome. They also sense that, up here in Congress, we have stacked all of these penalties or closed our eyes while the IRS has made these penalties become a reality. They think that we are doing this simply to raise revenues and pay off the deficit.

Do you sense any of that feeling out there? Or do you see any evidence of this out there in your study so far?

Ms. STATHIS. I have heard the same complaints; but I do not know how widespread they are; and I have no evidence to support that feeling.

Senator PRYOR. If I might say this—and I don't think there is a stronger supporter of the General Accounting Office in Congress than myself, and I know Senator Heinz is, of what you do. I have often said that you could abolish the legislative, judicial, and executive branches of the Government, but if we ever lose the GAO, we are done for because you do great work.

I would urge you to talk to some of these people—really, actual living cases, of people who not only help prepare returns but advise small business people, and the small business people themselves. I think you will see some things there that might lead your study into another direction or into additional directions, I should say; and I urge you to do this, and I hope you will.

Ms. STATHIS. As you may know, we are going to be taking a statistical sample in each of these 11 penalties and looking at individual cases of taxpayers. We are planning to look at the IRS records. One of the questions that has arisen is whether we should make any contact with those taxpayers.

What I am hearing you say is that maybe we should do that. I should forewarn you that, if we do that, that lengthens the study even more, particularly given the size of the sample we may have to review.

Senator PRYOR. Yes, we understand that. Mr. Wolters has traveled all the way from Kansas City, I believe. I would hate for you to come to Washington and say nothing. (Laughter)

Is there anything you would like to add?

Mr. WOLTERS. No, sir. (Laughter)

Senator PRYOR. You are a good witness.

Ms. STATHIS. He is in Washington a lot.

Senator PRYOR. Ms. Willis, do you have anything to add? I have noticed your nodding in agreement a while ago.

Ms. WILLIS. Chairman Pryor, the only point that I think I would like to emphasize, and it relates to revenue raising in terms of penalties, is that one of the things that we are having a very difficult time getting a handle on is how many of these penalties are actually collected.

The data that we have from IRS that are included in the annual report, for example, are on assessments and abatements. There are no numbers which actually tell us how many penalty dollars are actually collected. IRS aggregates this information onto the data base, along with liabilities, other interests, etcetera.

So, that is a very, very difficult question to get a handle on because you don't know how effective they are as revenue raisers if that is what you want. So, that would be the only caution I would use; that is, nobody knows what we collect in penalties.

We are not even sure what we assess.

Senator PRYOR. We do not know how many penalties we collect?

Ms. WILLIS. No, we don't, sir.

Senator PRYOR. How do we find that out?

Ms. WILLIS. You would have to change the data base so that the information is put on the master files where this information is aggregated that divides the tax liability from the penalty liability and the interest liability. It is all aggregated right now, as best we can determine.

That is one of the things that we are still working on to see if there is some way in the system that we can try and pull that out.

Senator PRYOR. We would like for you to work hard to find that for us. We need that information. We are very grateful.

Senator Heinz, do you have any questions?

Senator HEINZ. No, Mr. Chairman.

Senator PRYOR. We are very grateful to the three of you for appearing this morning.

Ms. STATHIS. Senator Heinz, I will be sending you a copy of the GAO report on the bad check penalty.

Senator PRYOR. On the bad check penalty?

Senator HEINZ. I will be looking forward to that. Thank you.

Senator PRYOR. He doesn't know what it is to write a bad check. He doesn't even know what you are talking about. (Laughter)

We have another panel coming now. Ms. Patricia Burton, Enrolled Agent, Partner, Gales Ferry Tax Service, Gales Ferry, CT; Mr. Gerald C. Portney, Esquire, Peat Marwick Main & Company, Washington, DC; and Mr. Kenneth W. Gideon, Esquire, Fried, Frank, Harris, Shriver and Jacobson, Washington, DC

We welcome you today, Ms. Burton, and we also thank you for serving on our penalty task force. Mr. Portney is also a member of the task force. We appreciate your coming, Gerald, once again before this subcommittee. Mr. Gideon is chairman of the task force. We appreciate very much, Mr. Gideon, not only your serving on the task force but serving as its chairman.

Once again, I want to thank all of you for your contributions to this effort, and I look forward to your statements this morning. We will invoke the five-minute rule, but we will have some lively questions at the end of your statements. Thank you. Ms. Burton?

STATEMENT OF PATRICIA BURTON, ENROLLED AGENT AND PARTNER, GALES FERRY TAX SERVICE, GALES FERRY, CT

Ms. BURTON. Thank you, Mr. Chairman and members of the committee. I have submitted a written statement for the record, which I request be entered.

Senator PRYOR. I read your statement in full, by the way, this morning, and it is a very, very well written statement.

Ms. BURTON. Thank you. I must say that I had not done anything of that nature before from my own perspective.

Senator PRYOR. That is why you did it so well.

Ms. BURTON. Thank you. It was a real challenge.

I would like to tell you that I am one of those small practitioners that you are talking about, and I do have a lot of comments on how people feel about it. In my statement, I wrote of the mood of the taxpayers and the frustration that I think they feel. I am speaking for my own clients and the 60 million people who prepare their own returns; at least, they did in 1986.

A lot of people came to us this year who had never before used a professional. Many of them were professionals themselves who had taken pride in doing their own taxes, in spite of the admitted hours it took them; and they want to minimize their tax burden.

Mistaken or otherwise, they are trying to do it by the rules. There may be a lot of people out there who are truly evading taxes; that is, they are not on the tax rolls at all. But few of the people being penalized today are among their number. The saddest cases are those people who didn't file on time because they didn't have the money to pay the tax. I think one of the biggest educational failures in our system is the fact that taxpayers do not understand that you can file a return on time without payment; indeed, that you should.

Inevitably, these people are self-employed. By the time the return is filed, the income and self-employment tax is computed, and the penalties and interest are added, the figures are incredible. Sometimes there are assets to pay them; sometimes they lose their homes.

Taxpayers who themselves timely file are not scornful of those friends who get in trouble with taxes because they see people who are in trouble with the IRS as victims, and many of them are.

Most of the people caught in even the most abusive tax shelter schemes were victims. They were simply low and middle income people who didn't understand the difference between investments that served the purpose of the law and those that abused it.

Our present penalty system is doing more to damage the dream of achieving true voluntary compliance than all the complexities and inconsistencies and unfairnesses in the Code that one can cite. There is no stimulus today for a non complier to get on track.

The people who inadvertently run afoul of the system are afraid to come in; and the ones who are in the system are being brutalized by the penalties. I don't know why there is so much objection to looking at some form of amnesty; but I do know there is no incentive for a taxpayer who makes a mistake to try to correct it.

I know we need penalties for failure to file and pay; but during the course of trying to pay off a tax liability, those penalties alone can equal 50 percent of the amount of the tax due. That is enough.

I don't oppose interest on the tax liability, but interest on penalties and interest on interest should stop the day the taxpayer takes steps to begin to deal with his problems. Taxpayers should be allowed to file an extension without payment. The extension provisions are of no use to those taxpayers who simply can't complete a tax return or pay an estimated liability on April 15, assuming they can figure out what the liability should be.

They would still be subject to one-half of one percent, but not five percent, of the amount due; and they would have an incentive for filing in a timely manner.

I am very concerned about the small business people. They receive the same instructions that General Motors does on how to do their 1099s and how to file their deposits and how to handle their W-2s. I have a client who paid $1,400 in penalties last year in Federal tax deposits before he gave up and asked us to take over, to compute the deposits and the dues. And every one of those penalties was a first time offense; each mistake violated a different rule.

I have tried to address myself to the problem as it affects the individuals. Most of the time, the penalty amounts are not all that significant. It doesn't make them fair. It only means that a lot of taxpayers may pay them rather than argue about them. In other words, we don't know how bad the error rate is.

I see I am running out of time.

Senator PRYOR. Go ahead. You are doing fine.

Ms. BURTON. With TRA-86, I feel that many of the penalties which have not previously been a problem for small taxpayers and preparers may well prove to be significant in the future. Will the fact that a taxpayer never heard the terms "disclosure," "material participation," "safe harbor," be a "safe harbor" from the 6661 penalties?

There is so much in the Code for which there are no regulations, no instructions, no guidelines that some credibility should be given to whether or not the taxpayer thought what he was doing made sense. The present penalty structure punishes average taxpayers who never heard of the"audit lottery game,"people who are terrified of the IRS and of having an audit.

These people, Mr. Chairman, are in the majority. They don't understand the interaction between societal needs and revenue raising. They don't understand the distinctions among the Congress, the courts, and the IRS and the implementation of the laws. They only know that something is wrong.

I would like to say how much I appreciate your holding these hearings and the opportunity to speak and the opportunity to serve on your task force. I wish more attention were being paid by the media to these efforts and those of the Internal Revenue Service to face and deal with the problem. Solving it will go a long way toward securing voluntary compliance and restoring taxpayer faith in the system. Thank you.

[The prepared statement of Ms. Burton appears in the appendix.]

Senator PRYOR. Ms. Burton, thank you for your statement. Also, I would like to let all the witnesses know that the full body of their statements will be printed in the record in the appropriate place; we really appreciate receiving those statements. I will have a few comments and questions in a moment. Mr. Portney?

Mr. Portney, before you begin, let me say for the information of all our witnesses and the audience this morning that, about 2 years ago, I started the effort on something that is intended to level the playing field with the IRS and the taxpayer—the Taxpayers' Bill of Rights. During this process, whenever I went off on a tangent, I received the very expert wisdom and advice of Gerald Portney. He kept us on track, and I think he gave our effort some degree of credibility and respectability.

I hope that this afternoon, at the latest Friday, the Technical Corrections Bill passed by the Finance Committee will contain the full body of the Taxpayers' Bill of Rights, now with 72 cosponsors in the United States Senate.

It will be a major reform—I imagine the most major reform of the past 30 or 40 years—in looking at the rights of the taxpayer. Gerald, let me say that we would not have taken that legislation this far without your wisdom and expertise.

Mr. PORTNEY. Thank you very much, Mr. Chairman.

Senator PRYOR. Thank you very much.

STATEMENT OF GERALD G. PORTNEY, ESQUIRE, PEAT MARWICK MAIN AND COMPANY, WASHINGTON, DC

Mr. PORTNEY. Thank you. As a citizen, I am very grateful that we have people in the Congress who are willing to sit and listen to citizens.

Ms. Burton and I have not rehearsed our testimony. I was sitting and listening to her and nodding and saying I think that she has said so much. That I agree with.

I did not bring any charts with me. I am impressed with those on display, and I know that they are accurate. What I want to spend my few minutes on, Mr. Chairman, is not charts. I want to spend my few minutes on expressing a view that I think may be the most important step and the least expensive step that we can take in trying to reverse a trend that we, collectively—the Congress, the Service, and the public—established in the 1980s.

In the first 68 years of our tax system, going back to the 16th Amendment, our tax system was based on the principles of voluntary compliance and self-assessment. And then, we suddenly changed the rules in five major tax bills in the 1980s. We changed it to one of misconduct and punishment, and it was an awful change to make; and it has caused extraordinary dislocation in the tax system.

I think we ought to proceed on at least three goals—these are my goals; and I hope perhaps others share them. One is that we ought to have a goal of improved compliance. Second, we ought to have a goal of increased revenues. Third, we ought to have a goal of a reduction in the level of adversarial tensions.

I think that certainly Commissioner Gibbs—whom I know the chairman has respect for and I also have great respect for—uttered these words which will never appear on any building in Washington. He said, and I quote: "If we had to pick a topic that singlehandedly deserved the credit for raising the adversarial tension of the tax system, I submit that penalties would win more votes than any other subject."

I think that we need to start with a simple set of assumptions—that have not a great deal to do with any specific penalty provisions. One is that there are lots of rules, regulations, and procedures in the tax system. There are lots of them.

Second, only a small, very small percentage of Americans, including those of us who spend every day working with them, understand most or all of them. Third, all Americans are less than perfect in terms of their knowledge of all of these rules.

Now, we have unfortunately these days a syndrome which is called the"tax cheat syndrome." It assumes that anyone who is less than totally, completely, fully compliant is therefore a tax cheat.

Mr. Chairman, that is one of the most misguided views that I think has ever been perpetrated, and I think we need to change that. I also think, in changing that, what we need to do is to ask Congress and ask the Commissioner of Internal Revenue to join together and to expand membership in the U.S. tax system and to eliminate the qualified memberships among those taxpayers who are honest taxpayers, who view themselves appropriately as compliant taxpayers, who try very hard to obey and follow all the rules and regulations but, from time to time make an innocent, non-negligent mistake.

Then, what typically happens, Mr. Chairman—and I live with this in my practice all the time, and I live with it with businesses as well as with individuals—is they discover the mistake. They go and investigate how it happened; it was an innocent mistake, whether it was through some computer system error or some clerk who did something wrong.

Then, they call me and they say: What is our exposure? Mr. Chairman, what I have to do is sit there and read many of 150 penalties, and usually the chief financial officer is sitting there with either a calculator or something to write with; and he proceeds to add those numbers. And he gets to a point, and he says: What are my chances of getting caught?

These are good, honest, well-meaning, compliant American taxpayers. And I have to give him the answer that my firm requires, which I believe in. I say to him: We do not advise on the audit lottery.

He and his colleagues then adjourn and make what is euphemistically known in the trade as a "business decision;" and they evaluate what the potential cost of coming forward is with what the cost of getting caught. Mr. Chairman, that is not the way the system ought to work.

Fundamentally in our system, it should always be in the best interests of the taxpayer to come in and self-correct errors; and the Internal Revenue Service ought to open up its arms and say: We are happy to have you; thanks for being a well-meaning taxpayer. If you owe some tax, we expect you to pay it. If there is some interest due, we expect you to pay it; but we are happy to have you as a fully fledged member of our tax system.

That philosophy does not require a single additional dollar of appropriations. Nobody has to worry about increasing the Federal budget. I would suggest Mr. Chairman for that group of taxpayers—and there are many of them out there—that I think you will find them coming forward because they want to come forward. They want to be part of the system. They are not tax cheats.

Right now, what is keeping them is the current structure and the administration of the penalty system. Thanks very much, sir.

[The prepared statement of Mr. Portney appears in the appendix.]

Senator PRYOR. Thank you, Mr. Portney. Mr. Gideon.

STATEMENT OF KENNETH W. GIDEON, ESQUIRE, FRIED, FRANK, HARRIS, SHRIVER AND JACOBSON, WASHINGTON, DC

Mr. GIDEON. Mr. Chairman, I am pleased to appear here today to support a thorough review of civil tax penalties. In particular, I want to commend you for both your public statements and support of this process and the appointment of the task force, which I think is going to lead us to some good results.

My practice experience includes not only service as a former Chief Counsel for the Internal Revenue Service, but as a representative of taxpayers in all levels of the dispute process. That practice experience has convinced me that civil penalties are both an appropriate and effective compliance tool.

However, recent legislative enthusiasm, shared by the Administration, for penalty increases has resulted in a substantial increase in the number of penalty provisions, as well as broader penalty coverage and enhanced penalty severity. This enthusiasm, I fear, for quick fix revenue raisers has led to less than careful consideration of the effects that might have on the compliance process.

The revenue-driven penalty system that we have constructed does not have adequate coordination. It does not distinguish between negligent and intentional noncompliance and good faith errors and simple mistakes and, perversely, it may punish that second category more strongly than it punishes the first.

Worst still, at this point most of the system's deterrent force for those who really need a deterrent is lost because taxpayers can't comprehend 150 different penalty provisions.

Now, this isn't to say that Congress should turn back the clock to what it was in 1980 or before. There are many worthwhile features of the current penalty structure that are worthy of retention; but I believe that penalties ought to be judged based on their effect in enhancing compliance, not on their ability to raise revenue.

Indeed, I believe that when penalties are forced to do double duty as revenue raisers and compliance enhancers, the revenue objective soon becomes the overwhelming force and overwhelms the compliance objective.

As a case in point, I offer the now well-known story of the substantial understatement penalty. Now, when we originally thought this penalty up, it was supposed to be a very low-rate audit charge that was to provide a downside risk for noncompliance. As it was enacted, however, it ended up with exceptions for substantial authority and disclosure and, largely for revenue reasons, went to up 10 percent.

Now, given the fact that the negligence penalty at that time was only five percent, something was wrong. Either this penalty was too high or the negligence penalty was too low, if we believe that penalty severity should vary with the degree of the offense.

I think the ultimate irony, however, was that when this penalty was increased first to 20 and then to 25 percent, and worse yet, was made retroactive. It couldn't possibly have deterred any behavior which had already occurred.

We all know what this was; this was a revenue raiser in a Budget Reconciliation Act. I think that the result we have now is that that penalty—as you are going to see some examples, I think, to show you—can impose on a simple mistake a 35 percent additional surcharge with the interest that it carries, given the usual time to assessment of this sort of thing.

I think that it is highly doubtful that this kind of geometric increase in severity can be justified on compliance needs, and I don't think there was even much pretense last time around that it was. It was a revenue raiser in a budget reconciliation.

Accordingly, I conclude that, if we are serious about penalty reform this time around, one of the first requirements is going to have to be that Congress has to take the pledge not to use these provisions as sources of revenue. Politically, increasing the burdens on noncompliant taxpayers is always going to appear to be easier than a general tax increase or repeal of some tax-favored provision that helps a lot of people.

The problem, though, that this view is tenable only in the abstract. The reality is the one that Ms. Burton has testified to this morning, the one that Mr. Portney has testified to this morning. The reality is that that money is coming from people who are well meaning, who try to comply, and frankly resent an enormous increase in their tax burden.

There is a good deal more to my statement, Mr. Chairman, but I am running out of time; and your questions will be more fun, anyway. (Laughter)

[The prepared statement of Mr. Gideon appears in the appendix.]

Senator PRYOR. Thank you.

Mr. Gideon, you were the Chief Counsel for the Internal Revenue Service for how many years?

Mr. GIDEON. Two years, sir.

Senator PRYOR. Now, the General Accounting Office has stated this morning that there appears to be quite a bit of arbitrariness, I guess you would say, or inconsistency in the imposition and applicability of many of our penalties.

Did you sense that when you were with the IRS?

Mr. GIDEON. For better or for worse, much of what we are talking about this morning began to be enacted during that period. I was there from 1981 to 1983. The over valuation penalty was enacted in 1981. The substantial understatement penalty was enacted in 1982. So, we had ideas; but, in other words, it was after my time frankly when the actual application came about.

I think that, yes, there has been inconsistency. I don't think anybody in the Internal Revenue Service would deny that. I think that, to be fair to them, part of the problem is that I think they have been confused about the signals that they have been getting from tax policy-makers. In other words: Were they supposed to go out there and raise a lot of money with these provisions? Or were they supposed to be doing something else with them? I think that what we have a chance to do here today is agree on a consensus of what that signal ought to be. What are they supposed to be doing?

One thing I do believe about the Internal Revenue Service is that I don't believe this is an effort to get people. I think that what we have is genuine confusion about what these provisions are about, and we need to send a clearer signal from the Congress and from the Administration about what we want done in this area.

I think these hearings will help clarify that process.

Senator PRYOR. Ms. Burton, you represent primarily, as you stated, small business people; and you have done this consistently for a number of years. How does the average small business person out there in America feel about the tax system and, more specifically, about the tax penalty system?

Ms. BURTON. As far as the tax system is concerned, it seems to me that the majority of my clients are really trying to handle their affairs in the most constructive, positive manner that is within the framework of the Code. In fact, I think that is probably—to be honest—one of the worst things about TRA-86, the numbers of things that people have done and planned and implemented that were thrown out the window; and they felt somewhat betrayed.

I think the record-keeping rules for the average small business are difficult to comprehend; but I really think that they are really trying to the best of their ability. Certainly my client with the $1,400 of penalties had a problem. I have to admit that one of his employees was not terribly effective, and she didn't understand and didn't ask; but every time he turned around, there was another penalty on just making a $500 Federal tax deposit.

It could have been funny, except that it mounted up so much; and every one of the things was a different one.

They resent it; I can't say that people don't resent that, if they are trying to obey the rules and they can't understand them.

My favorite short story—and I will make it short—is a taxpayer whose office I called and said: You have to make a Federal tax deposit. It was $603.84. Three days later, the bank officer called and said: I have opened the savings account for so-and-so, but I am not quite sure what I am supposed to do with it. She had no idea what I meant by a Federal tax deposit.

That was my fault, but nevertheless, the money was in the bank on the 15th of the month.

Senator PRYOR. I know you deal not only with your clients, mostly small business; but you also every once in a while sit across the table from the Internal Revenue Service—an agent or officer or a representative.

Ms. BURTON. Yes.

Senator PRYOR. Do you find a great deal of difference in which representative of IRS is looking at your particular client on a different day, or is there a consistency?

Ms. BURTON. Yes. I think certainly, when the examiner is an examiner trainee, it is a lot different from when you have an experienced auditor. I do think there is probably less within a district than there is among the districts.

When you were asking GAO if there was a better district to be in, I would say yes; there are a number that I would prefer to be in than in a number of others in terms of what practitioners feel is reasonable, fair treatment. I know that Commissioner Gibbs has been working very hard to eliminate this kind of thing, but it does exist.

There are districts that you really want to move your client's tax problems out of in order to resolve them more favorably.

Senator PRYOR. Some of your clients are undoubtedly assessed penalties which they feel they do not owe; but rather than fight the IRS and get caught up with all of that massive confusion, time, effort, and expense, they just pay the IRS. Now, would you say most of the people just kind of give up and pay the IRS whether they believe they owe that or not?

Ms. BURTON. Of course, I think presumption of negligence and the 50 percent of interest—those are new penalties that taxpayers feel are very offensive. They are supposed to be rebuttable. I try to write a courtesy letter on behalf of my client, for which we don't charge, because we feel we should do it. After the point that it is rejected, then you have to begin to think in terms of charging fees; and there is a limit as to how far you are going to go simply because of the system.

So, there are a number of people who have chosen to pay $50 or $75 on a situation that should have been waived. Because of the cost of fighting it.

Senator PRYOR. What is the most unfair penalty that you think today the small business person faces?

Ms. BURTON. The penalty for filing late being the same as the penalty for not filing at all; on the information returns, it is obvious. I mean, the person who doesn't even know about information returns or hasn't understood about the date—

I mentioned, I think, in my testimony of the small contractor who has 15 subcontractors, and suddenly it is March when he gets his records together, and he does his own taxes. Now, he had a $50 penalty for each of those 15 subcontractors for filing 1099s with the Service late. He also has a $50 penalty for each of them if it is found out that he didn't file 1099s.

It is not only an unfair penalty; it is not only unreasonable, but it certainly does nothing to stimulate compliance.

Senator PRYOR. Mr. Portney, you were with the Internal Revenue Service 26 years. You were one of the highest ranking officials with the Internal Revenue Service. I won't mention your answer, but I will mention the question I asked you one day when we were on a television show; and right before or right after the show, I asked you why you left the IRS. I am not going to repeat your answer.

You talked about the notion that penalties are only imposed upon those guilty of misconduct. I find that pretty striking coming from the Internal Revenue Service. When did all this take place? What about the change? When did we sort of change our attitude about this presumption?

Mr. **Portney**. Mr. Chairman, at a point in time, it seems to me that there were really two events that I think really started turning the Queen Mary around in the Potomac. The Service took an unprecedented step, I think it was in 1979, in going public with a tax gap that had heretofore never happened.

It was one of those things that we all kind of whispered about; we talked about it. We all knew that everybody wasn't paying everything; there was a gap in fact, but the then Commissioner decided to go public on the basis that, if he did not go public, Congress would not be in a position to respond. That got a lot of people's attention.

About the same time, I think that Congress became aware because the Service helped it become aware that there was widespread abuse among tax shelters. And people started looking at who was investing in tax shelters, and these were not people who were laundering drug money. These were not people who were involved in organized crime. These were people who wore three-piece suits and who were business people and otherwise legitimate taxpayers.

I think that somehow an image formed in the minds of some people that said what we have out there are tax cheats. People who invest in tax shelters are not paying their share; they are part of the tax gap. They are bad people, and what we need to do is impose a system of sanctions to get them, and I think that is how it all happened.

It all evolved in those five tax bills in 1980, and I think the tax cheat syndrome is with us today. Senator Heinz had mentioned the bad check penalty. I think there are several penalties in the Technical Corrections.

I would really wonder why it is not in the best interests of the issue and the tax system right now to just place a moratorium on any new penalties until these hearings and the studies can be brought to a conclusion. Let's find out what it is that we really need instead of putting more logs on this awful fire.

You know, there is a front page story in this morning's Post. I think it was fortuitous that the hearing is held today; it is an ominous story, Mr. Chairman, because it suggests that a study that was commissioned by the Office of Personnel Management shows that the Federal Civil Service is going to be in awful shape in the year 2000.

We can't wait until the year 2000 to start simplifying life not only for the taxpayers, but for those who have to administer the rules.

Senator **Pryor**. Yes. We always learn something from these hearings. I will admit in public that I am just learning; do we have new penalties in the Technical Corrections Bill that we are just about to consider?

Mr. **Portney**. There is a penalty, as I understand it, of $5,000 involving international transactions. Are you familiar with that, Ken?

Mr. **Gideon**. Yes.

Senator **Pryor**. I am glad you brought that to my attention. I will have to look at that; I did not know it.

Mr. **Gideon**. Chad Muller is aware of those penalties.

Mr. MULLER. There are two new informational penalties in the Technical Corrections Act.

Senator PRYOR. Fine. We will look at those. I may not be so supportive of the technical corrections after all, now that I know that. Let me ask a final question. Can we craft something, Mr. Gideon, to say that if the taxpayer goes in and finds a mistake and calls his practitioner—let's say, Mr. Portney or Ms. Burton—and says: I have found this error and I don't know what to do about it. I don't know whether to go in an confess my soul to the Internal Revenue Service and have penalties inflicted upon me or whatever.

Can we craft something there that would say that a good faith effort on behalf of the taxpayer would be substantial compliance and, therefore, no penalty? And what would constitute good faith? How do we legislate some description of that good faith? Can we do that?

Mr. GIDEON. Those are difficult concepts; but I think what is clearly an attainable goal, and one that I am encouraged to see the Commissioner's task force endorsing, is the fact that we can treat first-time offenders differently; and we certainly can restructure the system in such a way that we make it always in your interest to come in and do better.

In other words, there is no reason why there shouldn't be if not total absolution, at least very substantial abatement of penalties for the folks who come in and say I want to make it right.

Senator PRYOR. Conceivably, maybe add an interest on what was owned, but no penalty? In other words, waive a penalty but add the interest?

I think Ms. Burton mentioned in her prepared statement that taxpayers seem not to be as concerned about the interest as they are overburdened by the penalty and arbitrariness of the penalty.

Ms. BURTON. The penalty, for example, for not filing on time is five percent a month of the total liability to a maximum of 25 percent; and having reached that, then you have one-half percent a month for 15 months to a maximum of another 25 percent.

There is a new penalty that, after the assessment is made, the one-half percent goes to one percent; and all together, just the penalty, as in my statement about the young woman who lost her home, the penalty can easily reach 50 percent.

Now, on top of that, we are having interest on interest, interest on penalties, interest on taxes. There should be a point when the person begins to come to grips with the problem to at least eliminate the interest on the interest and the interest on the penalty.

She has lost her home. She still hasn't dealt with all of her tax problems; and it costs approximately $600 to $700 a month to stay current with how the penalties and interest are now growing.

It is hard to get out from under something like that, Mr. Chairman.

Senator PRYOR. I recently had a personal interview with an individual—I will not even name his State; I don't want to get him into further trouble—who has two assets. He is 65; he has a home and a car. The Internal Revenue Service is about to seize both as a result of a 1977 tax shelter; we have talked about shelters for a moment this morning.

He went to tax court, ultimately after an audit. I think he satisfied what they considered to be sheltered income; they said it was an illegal shelter. He took this to tax court, and it was 6 or 7 years in the court—roughly, a sum total of around $30,000. Today, he owes $204,000 in interest and penalty; the only two assets, the home and the car, are about to go on the block. That is not fair.

I don't think that is fair. I mean, this man thought this was a legitimate way to shelter some income. He is Chapter 11; I might say that. His business went in Chapter 11 some years back. There is an inequity in the system.

Ms. BURTON. I had tried to cut my comments short, but I do want to say that I appreciate your sponsorship of the Taxpayers' Bill of Rights very much.

Senator PRYOR. Thank you.

Ms. BURTON. I know that the IRS is trying to deal with some of these things administratively, and I know that they have reservations about it. I also think it would be very nice if, once it were passed, there were never any need to invoke the Taxpayers' Bill of Rights; but I think it is absolutely essential that we have it.

Senator PRYOR. There is no question but that many people in the Internal Revenue Service and some in the Treasury do not support the Taxpayers' Bill of Rights. That is natural and expected.

They have been adversaries throughout this year and a half. Let me just say, though, in all due respect to the Internal Revenue Service, that recently at an airport I ran into a young man—well dressed, briefcase—and he said: Aren't you Senator Pryor? I said yes. He said: I want you to know how much I support the Taxpayers' Bill of Rights. I said: Oh, thank you. Who do you work for? And he said: The IRS. I said: Why do you support it? He said: Because it will make us better, and it will make our tax system better.

I think he was speaking for a lot of people in the IRS who are out there dealing every day with the public. There are a lot of good people in the Internal Revenue Service, and I especially remember that one.

I want to especially thank the three of you for coming and for not only serving on our task force but the contributions that you have made. I wonder if there might be any final parting statements you would like to make? Gerald?

Mr. PORTNEY. Mr. Chairman, the only one is I think probably by way of echoing something Ms. Burton said. I think that if I had one opportunity to make one change legislatively, what I would urge wholeheartedly is the repeal of presumptive guilt. I fully agree that it is the most offensive provision. It is offensive to American jurisprudence.

I think that all of the evidence shows that people are outraged, and I think the Service's own recent focus group interviews conducted by a private contractor completely bear out how offended people are to be presumed guilty. I would urge that that be considered at some early point.

Senator PRYOR. I think the issue of presumptive guilt—just the issue itself, that one issue—should be and I hope can be the subject of a hearing early next year. I think that that is one of the things that I find does bother taxpayers a great deal; I really do. Thank you all.

Mr. **Portney**. Thank you.

Mr. **Gideon**. Thank you.

Senator **Pryor**. We have our third panel coming. We have Mr. James E. Merritt, Esquire, Morrison and Foerster; testifying on behalf of the American Bar Association, Tax Section, San Francisco, California; and Mr. Charles J. Muller, III, Esquire, Matthews and Branscomb; testifying on behalf of the American Bar Association, Tax Section, San Antonio, Texas.

We appreciate both of you coming from a very long distance. I am not quite sure about the two of you. Let me first ask this: Are you representing the American Bar Association, or are you speaking for the majority or minority positions of the American Bar Association on this?

Mr. **Muller**. Senator, the American Bar Association, as you know, is a very large organization. The Tax Section is just one segment of that bar association; and the American Bar Association probably works very much like Congress in the relationship to this committee, for example. We are a task force of the ABA Tax Section. We are speaking for the Tax Section, but have not been on the floor yet for the full ABA. So, we cannot profess to represent the whole ABA.

Mr. **Merritt**. We don't move as fast as Congress does sometimes.

Senator **Pryor**. Nothing moves as slow as Congress. (Laughter) I think we are going to call on Mr. Merritt first. Maybe they did this alphabetically.

Mr. **Merritt**. That is backwards, Senator. Mr. Muller should precede me because he is representing the majority view.

Senator **Pryor**. Fine. Mr. Muller?

STATEMENT OF CHARLES J. MULLER, III, ESQUIRE, MATTHEWS AND BRANSCOMB, TESTIFYING ON BEHALF OF THE AMERICAN BAR ASSOCIATION, TAX SECTION, SAN ANTONIO, TX

Mr. **Muller**. Thank you, Senator. I am Chad Muller. For the reporter, I made a comment a moment ago; and he needed to have my name on the record.

Senator **Pryor**. Yes.

Mr. **Muller**. Thank you very much for inviting us to appear before this committee and letting us express our views and the views of the task force. I want to also personally thank your staff, Senator. They were very good to us, and they really helped us prepare our material.

Senator, the points that I want to speak to first are those taxpayer penalties, and I want to comment that the way we got where we are today is reflected in my testimony because the taxpayer penalties essentially consist now of five penalties. Three of those penalties were in the tax law for a substantial period of time, were well proven and tried; they needed some work, but they were working well for some 40 or 50 years.

The three general penalties were the fraud penalty, the negligence penalty, and the delinquency penalty. Fraud applied to where a taxpayer tried to evade his tax. Negligence applied where a taxpayer intentionally disregarded the rules and regulations, or where he was careless to the point where he should be charged with some penalty. The delinquency penalty applied where the taxpayer was delinquent in filing his return or paying his tax.

In 1981 and again in 1982, for the reasons mentioned by Mr. Gideon and Mr. Portney, Congress overlaid on top of those three general penalties two specific penalties. One of them was the substantial understatement penalty, and the other was the over valuation penalty.

Those penalties, while they were coordinated with one another—that is, you would never have a substantial understatement penalty and an over valuation penalty applying to the same deficiency—were not coordinated with the three general penalties. So, those two specific penalties would then overlap or pyramid with the other penalty.

In addition, there were some problems that still existed in the penalty system that could have been corrected and still need to be corrected. One was that the negligence penalty was not specific; that is, once the penalty applied—the five percent penalty applied—it would apply to the whole understatement even though some substantial portion of the understatement was not negligently induced. It was a mere mistake or something that you wouldn't want to charge the taxpayer for.

As a result of that five percent penalty applying to the whole deficiency, taxpayers who had a small amount of negligence could be faced with a very large penalty. A Supreme Court decision—I think in 1986—showed a situation where they had a very small penalty and a huge nonfault inventory adjustment to their tax return and had to pay a huge penalty when only a small item was negligent.

In addition, the delinquency penalty, Senator, was not coordinated with the three penalties; and it would overlap and apply in the same situation. Then, as you know, Congress began adding interest components. It was well thought out, but the interest components then pyramided again; and we ended up where we had an interest component to the fraud penalty, an interest component to the negligence penalty.

We had tax-motivated interest enhancement, and we had two different rules for placing the interest in effect on penalties.

In summary, our recommendations ask this committee to go back and take a look at the three general penalties and see if we can't coordinate them and make them work better. One of the things we recommend, for example, is that all penalties be fault-based.

Senator PRYOR. Be what?

Mr. MULLER. Be fault-based, that is, that there be some preliminary determination that the taxpayer has done something wrong. That is why the negligence penalty is the appropriate vehicle for that circumstance.

If we take the negligence penalty and increase its weight—maybe five percent is too low—where you have a taxpayer who is intentionally trying to take advantage of the audit lottery, if we can distinguish negligent conduct between that conduct which is intentional disregard of the rules and regulations from that conduct which is just simply carelessness—simple carelessness—applied two ways, and then just hone that penalty down to where it just applies to the actual understatement that is a result of the bad conduct, then you have a penalty that ought to work as a general enforcement device; and it won't be a penalty that will be imposed upon taxpayers who didn't do something wrong.

We also would like to see the delinquency penalty honed down so that it applies in a very limited circumstance and does not pyramid with the other penalties. We think the substantial understatement penalty and the over valuation penalties could be eliminated; they are just redundant.

We think all these interest components could be eliminated. If the taxpayer pays prime interest rate and a penalty on his conduct, that should be sufficient to cause him to comply with the law and to compensate the Government for his misbehavior. Thank you, sir.

Senator PRYOR. I believe you are Chairman of the Penalties Task Force of the American Bar Association, are you not?

Mr. MULLER. Yes, sir.

Senator PRYOR. The presumptive guilt area that Mr. Portney raised, does this concern the task force?

Mr. MULLER. Yes, it does, Senator. There are three areas where there are presumptions in the penalties. For example, one we don't ever talk about it that way is this substantial understatement penalty, which is a presumptive penalty. It applies presumably at 25 percent rate to conduct, once you reach a certain mathematical formula. This mathematical formula is without regard to your intent, and you have this penalty.

It is a presumptive penalty. Also, you have the fraud penalty, which has a presumptive element to it. For example, if you have a taxpayer who has an understatement—I will just take the number $20,000—$1,000 of that $20,000 understatement was fraudulent on this part; the other $19,000 was an innocent mistake. The law presumes that the whole $20,000 is fraudulent and applies a 75 percent penalty with an interest component on top of that.

The other presumption arises in what you have heard called the information reports, where a taxpayer misses an information item on his return. It is presumed that that is negligent; and now, unless Congress corrects the situation, that negligence penalty would not apply only to the small information item that he missed, but any other adjustment that goes to his tax return.

So, those are the three areas of presumption, and we have addressed those in our report, sir.

Senator PRYOR. I want to thank you. I may have some questions in just a moment. I don't know which of you or if maybe both of you brought our charts this morning.

Mr. MERRITT. Mr. Muller is responsible for the fine charts you have before you, including the multicolored one. Put the required break here .

Senator PRYOR. All right. In a moment, we might get you to explain the multicolored chart. I think you have addressed this to some degree, but why don't we ask you to do that right now?

Mr. MERRITT. However you wish to proceed, Mr. Chairman.

Mr. MULLER. The purpose of the charts was to show this committee how these penalties overlap, and let me go to this colored chart behind you, sir, first. Here, what I have done is I have the two general penalties; the red penalty is the fraud penalty. It can begin to apply at a zero understatement and go on for the entire understatement; and as you recall, it is a 75 percent rate.

Beneath that, the yellow bar is the negligence penalty. It applies where a taxpayer does not have a reasonable basis to his tax reporting. He could either be intentionally disregarding rules and regulations, or the taxpayer could just be careless. That, as you know, is a five percent penalty; but it applies to the entire understatement.

Then beneath that conduct and a lesser conduct, although a higher rate, is the substantial understatement penalty. As you can see, it does not kick in until you get to a 10 percent understatement. There is a delay in the time it kicks in; but once it kicks in, it covers the whole spectrum. It overlaps with the negligence penalty in yellow and with the fraud penalty in red.

So, when you have that overlapping area—for example, up in the fraud penalty area—you have the red representing a 75 percent rate plus the interest component and then there is an additional 25 percent; so, in that area, the taxpayer is paying a penalty in excess of 100 percent of the taxes, plus interest.

Senator PRYOR. Now, these three sections of the Tax Code, when were they added?

Mr. MULLER. The fraud penalty has always been there in the law.

Senator PRYOR. The fraud section has always been there?

Mr. MULLER. Yes, it has been in there since 1913. It came from the old excise tax laws. Then, the negligence penalty was added in its present form generally in 1924; it actually came in 1918, but it was modified in 1924.

Now, the substantial understatement penalty was added in 1982, and it is the one that doesn't seem to fit. I will go these charts for just a minute because I wanted to show you how the delinquency penalty then overlaps on top of these.

Senator, in the first example, we have a taxpayer who has filed a 1987 return; and he has a tax liability of $30,000. But on audit, the IRS assesses an additional $1,000 because this taxpayer carelessly failed to maintain a record—for example, suppose he failed to maintain his automobile mileage records or something of that sort.

So, he pays five percent of $1,000, or a $50 negligence penalty, plus there is a little interest component that goes with it. Now, under our proposal, we think the five percent rate probably is too small; and we would propose that the simple negligence rate be 25 percent. This is a fault-based assessment, a $250 assessment, for something that the taxpayer did that was fault-based. Now, that is the only situation where we would have a higher penalty.

In example number two, we have the same taxpayer, except that this time the taxpayer has had an adjustment to his tax return that was not fault-based. It might be some carry-back; it might be some inventory adjustment. It is something that was technical, that the Internal Revenue Service is correct in its interpretation of the law; but you can't charge the taxpayer with a fault because he was doing the best he could to comply with the law.

Here, this taxpayer pays a five percent penalty, but not just on the $1,000 that was negligence-based. Now, he has to pay a five percent penalty on the entire $31,000 adjustment, plus he has to pay the substantial understatement penalty of 25 percent on the entire $31,000 adjustment.

So here, this same taxpayer who has done nothing more wrong than the taxpayer in example one is paying a $9,300 penalty plus interest; and he didn't think to do anything wrong.

Senator PRYOR. He had no intent to defraud?

Mr. MULLER. No.

Senator PRYOR. He had no intent to underpay?

Mr. MULLER. No. He wasn't even really negligent. I mean, he was doing the best he could do except for the $1,000 item.

And in this next example, example five shows you what happens with the delinquency penalty; and it becomes outrageous. Here, this same taxpayer pays a month late filing his tax return; and all of a sudden, his delinquency penalty is 25 percent of the $31,000—I am sorry—that should be five percent. I got that wrong.

He has a delinquency penalty of five percent of the $31,000. He has a negligence penalty of five percent, but not of just the $31,000; he pays it on the entire adjustment—the entire $61,000—even though he paid $30,000 timely to the Internal Revenue Service with estimated tax payments. Now, because the delinquency penalty and the negligence penalty interact, he has to pay five percent of $61,000; and the same thing happens with the substantial understatement penalty, that is, he does not get credit for the taxes he paid timely. So, he pays 25 percent of the entire $61,000.

So, you can see that penalty just pyramids and compounds the problem even more.

Senator PRYOR. I really appreciate your bringing these charts. We are going to have these charts reduced for the record. They will be an official part of this record, and we really appreciate your providing these charts for us.

Sometimes, to get information to Senators and Congressmen, it takes the most basic type of information such as this; and that helps us a great deal, I must say.

Mr. Merritt, you have come a long way; you are from San Francisco.

Mr. MERRITT. That is correct, Mr. Chairman.

Senator. We look forward to your statement and your contribution this morning.

STATEMENT OF JAMES E. MERRITT, ESQUIRE, MORRISON AND FOERSTER, SAN FRANCISCO, CA, TESTIFYING ON BEHALF OF THE AMERICAN BAR ASSOCIATION, TAX SECTION

Mr. MERRITT. Thank you very much. By way of background, I have served in a couple of capacities with the Internal Revenue Service at various times; and my private practice ranges the gamut from large corporations to low income individual taxpayers. So, I have seen these situations in a variety of circumstances.

I will try to concentrate on areas that have not already been discussed by prior witnesses today. My mission before you is to cover the part of the ABA Tax Section's Task Force Report that deals with third party penalties and then to present the minority view. The fact that my views expressed now will differ or seem to differ does not indicate or shouldn't indicate that there is not a great deal of agreement, not just among the people in the American Bar Association, but with all the witnesses you have heard today and what is coming out in other committees that are considering the issue.

For example, I don't see any disagreement that the principle of penalties should not be to punish. You don't want to punish people who are complying, who are making good faith efforts to comply. I don't see anybody saying we should punish these people. I hear everybody saying we don't want to do that.

I have heard no one, and we saw no one in our consideration here, who disagrees with repeal of the valuation penalties, and I don't want that to be missed.

Senator **Pryor**. Would you make that statement again? You found no one who disagrees with what?

Mr. **Merritt**. Repeal of the valuation penalties.

Senator **Pryor**. I see.

Mr. **Merritt**. We have recommended that in our task force report; there are three of them, in sections 6659, 6659(a), and 6660. There are areas, though, where we do disagree; and I will concentrate on those in just a moment.

Let me talk about the third party penalties, and there are a variety of third party penalties, the principal of which are focused on tax return preparers. These are fairly minimal dollar amount penalties of $100 and $500 per incident for a preparer who is either negligent or willfully fraudulent in assisting the taxpayer in a mistake in a return.

The big lesson that I would like to draw from the experience we have had with those penalties—and these were enacted in 1976—is to reach out and give guidance to a compliant group of taxpayers. From 1976 to 1980, there was no guidance provided by the Internal Revenue Service to preparers on how to avoid these penalties.

They were assessing penalties at a rate in excess of 30,000 per year at that time. In 1980, there were discussions between the Service and the preparer industry. As a result, a series of revenue rulings and a revenue procedure were published, which provided guidance as to how to conduct your affairs so that you would not be subject to these preparer penalties.

As a result, the instances in which penalties are assessed have dropped down to the 10,000 level—a substantial decrease in the number of penalties being assessed—and I submit you are getting compliance.

The lessons to learn from that are emerging from what you are hearing in a variety of circumstances from different people. That is, with regard to people who are trying to comply, first-time offenders, small business taxpayers, information reporters certainly fall in to this category. It may be best not just to have a penalty out there, which will be automatically assessed, but to provide guidance as to how to avoid that penalty.

What should you do in trying to set up a small business? What should you do in preparing form 1099s or information reports to avoid penalties—not "aha, we got you again, and here is a $25 or a $50 penalty."

There are technical corrections that should be made with several of the third party penalties; most notably I would suspect would be the section 6700 penalty on abusive tax shelters, where there is no statute of limitations, and there is a split between the courts as to how to compute the penalty.

We have made recommendations with regard to these issues.

With regard to the minority report, let me address that now. That goes to the substantial understatement penalty of Section 6661, about which we have heard a great deal.

I am in favor, and the minority is in favor, of retaining that penalty as opposed to repeal of it; and I would like to give you an example or two of why I think that is very important. I worked on this at the time that Mr. Gideon was Chief Counsel also, and I recall the discussions we had with staff persons on the Hill, the proposals that we were making were to have a no-fault downside penalty.

You may recall that former Commissioner Kurtz was very much in favor of initiating something like this. At the time, an overly aggressive taxpayer had no risk, if he took a very aggressive position, as long as it was couched in the"reasonable basis"concept. Then, he could deduct $50 million; and indeed, I had a situation involving a $50 million deduction.

The question was not is it proper; will we win in court? The question was: Is there reasonable basis so I won't be subject to the negligence penalty?

If he wasn't subject to the negligence penalty, then he would make money because it would take 3 or 4 years for the IRS to audit. The interest rate at that time was not a commercial interest rate, and the interest rate arbitrage which a person could benefit from would have generated $3 or $4 million.

You have changed that ball game. More importantly perhaps than changing the ball game on individual taxpayers or corporate taxpayers, you have changed the ball game in the marketplace. This ties in to the point Mr. Portney alluded to in terms of the birth of tax shelters.

The IRS lost control of the marketplace for tax savings ideas, and I have my own views as to why that occurred. You don't want to do that again at this time. People are out there selling tax savings ideas. Now, because you have section 6661, they have to represent that they have substantial authority; or else the taxpayer says: I don't want to touch something where there is no substantial authority because there is going to be a big penalty levied against me.

So, you have upped the level of practice, both with regard to what taxpayers are doing and with regard to what the tax savings industry is trying to peddle. We do think, and we urge that there be modifications made in the penalty, it is too high a rate. The 25 percent is much too high; the original 10 percent might have been too high.

Definition of authority. It is unconscionable to punish a taxpayer for interpreting the tax law the same way the IRS does, and yet we do that. There are some reasons I understand why you don't want to give an imprimatur of authority to written determinations; but I can think of no reason why the IRS can put out a proposed regulation and yet, if a taxpayer takes the same interpretation of the tax law as the proposed regulation, he cannot consider that proposed regulation to be authority.

That kind of thing is going to get people marching to your doors, and you don't want that.

Last, it should be clear that it be coordinated with other penalties to eliminate the problems Mr. Muller has pointed out on his multicolored graph. You should not have a pyramiding of the substantial understatement penalty on top of the civil fraud or negligence penalties or a delinquency penalty either, unless it is both delinquent and a substantial understatement.

And last, you have to do something about the honest mistakes. You want to make sure that doesn't apply to those. My time has run out, and I apologize for exceeding, Mr. Chairman.

[The prepared statement of Mr. Merritt appears in the appendix.]

Senator PRYOR. Both Mr. Merritt and Mr. Muller, we appreciate very much your testimony.

In the American Bar Association's study, wasn't this study gleaned from the interviews and experiences of practicing attorneys in the tax arena? I assume that is so.

Mr. MERRITT. That is correct.

Senator PRYOR. How many cases do we find today of the civil penalties actually being more than the original tax due? How many cases are we finding like this?

Mr. MULLER. I just surveyed the recent law in 1987 and 1988, and there are about 20 cases out of the tax court that we found. Now, that just represents the court-decided cases. That doesn't represent all the taxpayers who paid the taxes and penalties without going to court.

I would say in the predominant number of situations where a taxpayer is audited, you are going to have multiple penalties applied to an understatement unless the auditor is absolutely convinced that the understatement was the result of an innocent or accidental understatement.

Senator PRYOR. Now, we have over 150 penalties. They are growing by leaps and bounds. Mr. Portney has even brought out the fact this morning that we are about to possibly adopt another one in the Technical Corrections Bill, that frankly I don't think anyone knows about. How many of these could we eliminate?

Mr. MULLER. You have to break them down into three areas. For example, in the area of the taxpayer penalties, we think right off you should eliminate the substantial understatement penalty.

Senator PRYOR. That is 6661?

Mr. MULLER. That is right.

Senator PRYOR. An area where you and Mr. Merritt may have some disagreement?

Mr. MULLER. Right. And then there are three over valuation penalties—6659, 6659(a), and 6660—that should be eliminated; and there is agreement on those.

There are also the interest components that could be eliminated effectively.

Senator, in the area of information reporting, you have heard the number that there are 153 penalties; 53 of those penalties are information reporting penalties. Now, the problem we have with the Code is that every time we ask for a new information return from a reporter, we also have to back up that law with a penalty because, if you don't back it up, then presumably the information reporter will have no incentive to do what it is the law requires him to do.

The question I have is: Do you have to have 53 different penalties in order to encourage compliance for 53 reports? The purpose of our report was that there should be some way to take those 53 penalties and consolidate them down into a simple system that involves four or five general provisions of the law and that would be generically applicable to any failure to file an information report.

In that way, that system could be consistently applied. The imposition and abatement criteria would be consistent, and it would be something that would be uniform for all information reporters.

So, what I have just said is that I have described a situation where we could take 50 or 60 different provisions out of the Code, just with those comments.

Senator PRYOR. Yes.

Mr. MERRITT. I would have a minority view. I think you can get it under 25.

Senator PRYOR. Yes.

Mr. MERRITT. A little more conservative.

Senator PRYOR. I would like to take even more than that if we could find the way to do it. I want to thank both of you this morning. We are going to print your full statements in the record. Also, as I have said, we are going to include the information in the charts in proper form.

We are very indebted to you and to the American Bar Association for your findings and your recommendations. Thank you very much.

Mr. MULLER. Thank you, sir.

Mr. MERRITT. Thank you, Mr. Chairman.

Senator PRYOR. We are going to take a short recess, and we will be back in four minutes.

[Whereupon, at 11:06 a.m., the hearing was recessed.]

AFTER RECESS (11:12 A.M.)

Senator PRYOR. We will reconvene the hearing now. The last panel consists of Mr. Craig Rhyne, President, Rhyne Precious Metals and President, Washington State Coin and Bullion Dealers Association, testifying on behalf of the International Council of Tangible Assets, Seattle, WA; Mr. Henry C. Ruempler, Tax Counsel, American Bankers Association, Washington, DC; and Mr. Thomas Cotter, Aetna Life Insurance Company, testifying on behalf of the American Council of Life Insurance, Hartford, CT.

Mr. Ruempler is substituting this morning for Mr. Jonathan Allen; Mr. Allen is a member of our penalties task force. Mr. Allen was taken ill yesterday and could not come to the hearing this morning; and we appreciate your being here this morning, Henry.

We would ask the panel to proceed. We will ask Mr. Rhyne to go first.

STATEMENT OF CRAIG RHYNE, PRESIDENT, RHYNE PRECIOUS METALS, AND PRESIDENT, WASHINGTON STATE COIN AND BULLION DEALERS ASSOCIATION, SEATTLE, WA, TESTIFYING ON BEHALF OF THE INTERNATIONAL COUNCIL OF TANGIBLE ASSETS

Mr. RHYNE. Thank you, Mr. Chairman. My name is Craig Rhyne; I am a member of the Board of Directors of the Industry Council for Tangible Assets, the National Trade Association of Coin and Bullion Dealers located here in Washington. I also serve as President of the Washington State Coin and Bullion Dealers Association, and I own Rhyne Precious Metals in Seattle.

We buy and sell coins, such as the American eagle coins; and I would like you to see them, Mr. Chairman, if you haven't seen them. I brought them along.

Senator PRYOR. Good.

Mr. RHYNE. I was instructed not to give them to staff until I had actually started. (Laughter)

I appear today to urge this panel to take action to relieve those in my business of onerous, confusing, and possibly illegal IRS reporting requirements. Because of the large number of coin and bullion dealers, many of whom are one or two person operations, and because there are relatively few product options, the profit margin is very small.

I will show that the broker reporting requirements not only hurt the legitimate dealer, but deprive the Federal Government of significant revenues. First, some background.

In accordance with the TEFRA bill of 1982, "brokers" were instructed to file 1099(b) reports when purchasing commodities regulated by the Commodity Futures Trading Commission. These reports, it was said, would stop those who would avoid reporting their capital gains.

The 1984 proposed regulations have never been finalized and, as a result, there is no consensus as to what exactly those reporting requirements are. An IRS agent has been auditing a Beaverton, Oregon dealer for 5 months, and he now says that a 1099(b) has to be filed on all transactions of $20 or more.

I brought to show you 20 of the pre-1965 90 percent silver coins. Now, this is $20 worth; and if you brought these in, Mr. Chairman, I would have to take your name, address, and Social Security Number. Then, I would have to do a 1099(b), according to this IRS agent in Beaverton, Oregon.

Senator PRYOR. Has the same rule been applied to all the coin dealers?

Mr. RHYNE. That is the curious thing. In other parts of the country, we are told it is $100. Another IRS agent says it is $250; another one says it is $600. It is quite confusing.

In order to find out just how much a small to medium sized firm would be burdened by filing these requirements, I hired the West Coast CPA firm of Moss Adams. They studied carefully the transaction costs, the computer requirements, and the related costs of filing.

For a medium-sized dealer such as myself, broker reporting requirements would add $10 to each transaction. Now, you can see I am not going to make ten bucks on that huge silver deal, and it makes it absolutely impossible for the "mom and pop" operation, which most of our members are.

Of course, the costs would go down for large firms as they can amortize their computers over far more transactions. What that means is that the large companies are given a very competitive advantage by these regulations.

The bottom line is this: Dealer profit margins are so small on precious metals investments that, when a client sells to us, it is usually one percent to two percent; that is our total gross profit margin; that the cost of the regulation far exceeds the profit on transactions unless the transaction is at least $2,000.

It is important to add here that the lost income tax revenues as a result of industry-wide compliance with 1099(b) reporting regulations would not be made up by improved compliance due to individual taxpayers reporting their supposed big precious metals capital gains.

My colleagues and I sympathize with the legitimate public policy goal of curbing tax evasion. However, the prices of gold and silver have not been going up; inflation is down, and all the record keeping that we might do will document mostly capital losses, not gains. They haven't made any gains.

In fact, because of this, and because the 1099(b)s will cost the dealers millions of dollars to comply, we believe the regulations will actually cause the U.S. Government to lose as much as $42 million in income taxes per year. That estimate, I think, is high, however, because many of the dealers would have to go out of business.

What is the IRS doing today? The answer depends on the region of the country you are talking about. In some parts of the Nation, there seems to be no enforcement. In others, there seems to be spotty and capricious enforcement. In at least two cases, the enforcement agents do not seem to be looking for the unreported capital gains at all; rather, they are trying to discipline the dealer.

One dealer, for example, was told: If you file your own records, I want every transaction over $100; but if I have to go through it or go after every one, it will be $50 or more.

One dealer in Nevada—and this is incredible—dutifully filed boxes of 1099(b) forms. He was asked by the local IRS officers to file them on magnetic media; so he sent them to a Los Angeles firm, paid $8,000 to have them put on magnetic media. When he got them back, there was no question as to his cooperation or the accuracy; but he was fined $50,000 for late filing. I see my time has expired.

Senator PRYOR. Go ahead. Complete your statement, if you like, since I interrupted you a moment okay.

Mr. RHYNE. All right. Another dealer was fined $5,000 in spite of the fact that his accountant was told by two separate IRS offices that he was not a"broker" and thus not required to file. In fact, many dealers are in the same situation.

I have a letter for you, Mr. Chairman, from Robert McIntire from Jacksonville, AR, which says in part: "This IRS reporting requirement is going to put me and many other small businesses out of the business of buying U.S. gold and silver coins and other bullion coins. This is a hobby-related business, and we don't need this overhead. I cannot afford the IRS magnetic reporting system and making reports on all the silver and gold coins that we handle weekly for the small profit that we make."

What we are seeking, sir, is equitable treatment. First, we need a redefinition of "broker." If an individual comes into my shop and wishes to sell me American eagle coins, such as I showed you, which I intend to hold in inventory for resale, I am not acting as a broker. I am a principal.

Second, we seek treatment under the same rules which are now used to handle paper currency transactions. We must report all currency transactions over $10,000; that is fine, and that de minimis rule of $10,000 would suit us just fine.

Third, we urge the Treasury be required to live up to their own obligations under the Administrative Practices Act, which requires Federal agencies to make provisions for the effects of their regulations on small business.

Fourth, because of the confusing nature of the regulations, we urge that the IRS be banned from seeking to impose penalties for noncompliance with the proposed and promulgated 1983 and 1984 regulations.

I thank you very much for giving me this time. Any questions, I will be glad to answer.

[The prepared statement of Mr. Rhyne appears in the appendix.]

Senator PRYOR. Mr. Rhyne, I appreciate your statement. I have three or four questions I will ask in a moment. I will now go to Mr. Ruempler.

Mr. RHYNE. Thank you.

Senator PRYOR. Thank you very much. By the way, I want the Ethics Committee to know that I am getting ready to return these coins now. (Laughter)

Mr. RHYNE. Thank you, sir.

Senator PRYOR. I am on the Ethics Committee, by the way; and they don't look kindly on our accepting gifts, especially gold and things like this, unreported. Henry?

STATEMENT OF HENRY C. RUEMPLER, TAX COUNSEL, AMERICAN BANKERS ASSOCIATION, WASHINGTON, DC

Mr. RUEMPLER. Mr. Chairman, I know that Jon Allen would like to be here to present the testimony this morning, but he is unable to do so. The testimony is to present the views of the American Bankers Association, which represents commercial banks of all sizes and types across the country and whose member banks make up about 95 percent of the industry.

Mr. Chairman, about 9,000 of our members are what we would call "community" banks, and they really fit the term "small business" that you used earlier today. We applaud your efforts to review the penalty provisions of the Code which have grown so numerous that I don't think they really can be implemented in a fair and equitable manner.

My comments this morning are directed largely at the provisions affecting information reporting, taxpayer identification number matching, and backup withholding.

The commercial banking industry, like other financial institutions, recognizes the importance of the IRS efforts to close the tax compliance gap through these information reporting rules; and indeed, we have done as much as any other party to further the efforts to have a clean system of TINs and to give the IRS the information necessary to collect the revenue that is due.

The vast amount of monetary and human resources that the commercial banking industry has expended in this regard has significantly benefited the IRS in identifying and collecting the revenue.

Unfortunately, however, the IRS implementation of these penalties has been perceived by information reporters as being arbitrary and, in some cases, divorced from reality. My statement lists 13 separate penalties that could be applied in the case of a simple savings account, where information reporting is required to the IRS.

Our first principal point, Mr. Chairman, that we would like to make is that the IRS imposes penalties on the bank for failing to provide information that only the customer can provide or verify. The GAO report that came out earlier this month states: "We agree with payors—that is, among others, commercial banks—that they should not be asked to serve as enforcement agents for resolving incorrect TINs resulting from circumstances beyond their control."

Now, Congress has already provided the IRS with the authority to apply a penalty on the customer, if he fails to provide a proper TIN; but so far, the IRS hasn't used that authority with the same vigor that it uses to go after the mayors. Direct contact with the taxpayer is the best way to get the right number, but unfortunately, it seems to be easier to levy a penalty on the bank.

The second key point that we want to bring to the attention of the subcommittee this morning is that penalties are applied by the IRS for incorrect TINs where the bank fails to perform due diligence to the "nth" degree. Let me give you a good example; this is a true story.

A large bank with hundreds of branches across the State undertook all of the separate mailings required by the IRS regulations, revised its computers and its software, trained its personnel about the new procedures required for opening accounts, at a cost of several million dollars. They really made the effort and expected to fully comply.

It discovered too late, however, that at one branch for a period of about 6 weeks, accounts were opened by an employee who failed to get the proper IRS form. So, when the notices came in about the incorrect and missing TINs, the responsible bank officer could not certify under penalty of perjury that due diligence was performed on every account; but certainly, they had made a substantial effort to do so for hundreds or thousands of accounts throughout the bank system.

The IRS was not impressed with their efforts, and the IRS applied a $500,000 penalty on the bank for every missing and incorrect TIN.

Employees in the banking industry are human, Mr. Chairman, and they will make mistakes. Certainly, IRS employees make mistakes from time to time on administering the tax laws. Shouldn't there be some reasonable level of tolerance for error before a penalty is applied?

The IRS Commissioner, in response to the GAO report, wrote to the GAO and said that "penalties should not be a first resort in achieving compliance if the payer is sincerely trying to comply and has instituted reasonable business practices to assure compliance." Now, if he wants to give that statement vitality, I would suggest that they revise their penalty program to incorporate a qualitative "substantially complied" rule that would say that there would be no penalty if there was substantial compliance by the filers of information returns.

Mr. Chairman, those are the two principal issues we wanted to bring to your attention. We have five other specific recommendations in the testimony, and we would be glad to work with your staff to fill those out. I will be happy to answer any questions you have.

[The prepared statement of Mr. Ruempler appears in the appendix.]

Senator PRYOR. And let me also tell this panel that your full statements will be printed in the record; and we appreciate very, very much, Mr. Ruempler, your coming this morning, especially on such short notice. Mr. Cotter of Aetna Life Insurance is our next witness. Mr. Cotter, we welcome your testimony this morning.

STATEMENT OF THOMAS COTTER, AETNA LIFE INSURANCE, HARTFORD, CT, TESTIFYING ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE, ACCOMPANIED BY STEPHEN KRAUS, SENIOR ASSOCIATE GENERAL COUNSEL, ACLI

Mr. COTTER. Thank you, sir. My name is Tom Cotter; I am from the Aetna Life Insurance Company. I am a tax consultant for Aetna. Part of my responsibilities is determining the taxation of our products, reporting of those products to the recipients, and determining if withholding is applicable against those products. I am joined today by Mr. Stephen Kraus, Senior Associate General Counsel of the American Counsel of Life Insurance. I am appearing today on behalf of the American Council of Life Insurance.

My testimony is directed primarily at the problems encountered by the insurance industry in attempting to comply with the information reporting and withholding requirements. The insurance industry appreciates the opportunity to present its views on information reporting at this time, and we welcome your committee's looking into this particular issue.

I listened this morning to the testimony of a number of individuals who spoke on behalf of small business. Small business is not the only ones affected; big business is, too. With regard to trying to comply with these regulations and trying to implement these regulations, our costs are staggering.

With regard to the accompanying penalties, our exposure is also staggering, given the numerous opportunities for inadvertance and the very stringent requirements.

During the past several years, information reporting requirements and accompanying penalties have increased significantly. The insurance industry appreciates congressional and IRS needs to implement compliance efforts through the matching of taxpayer identifying numbers, known as the TIN matching program.

However, rule-makers need to have a greater appreciation and sensitivity to the burdensome and costly impact that information reporting has on the day-to-day business operations of information reporters and a better understanding of our products and our operations. Much could be accomplished through enhanced opportunities for dialogue between rule-makers and information reporters.

One of the areas of concern is the TIN notification process, which we believe can be improved in a number of ways. For example, the Code provides that in the case of any reportable payments, if the secretary notifies the payor—referred to as the B Notice—that the TIN furnished by the payee is incorrect, the payer shall withhold from such payment.

The B Notice sent by the Service to the payer consists primarily of a computer tape prepared in IRS format, listing those payees with missing or mismatched TINs. There seems to be a prevailing assumption that it is a minor task for information reporters to immediately allocate computer time and data processing resources to respond to these notices. This assumption is erroneous.

Receipt of the notices, especially at year end, is extremely disruptive to the work flow of business operations since most companies are faced with a crush of year-end reports. Information reporters must not only cope with the information demands of their business but also with the growing number of demands from both Federal and State regulatory agencies. In this regard, the Service has announced that in response to the GAO criticism that it is not cooperating sufficiently with payers, it would send a B Notice in November of each year, commencing in 1988 for the 1987 reporting period.

We are unable to understand how a November notice aids us in any way. November is the height of our year-end reporting period. Since reporting forms need to be mailed to the payees by January 31, it would be virtually impossible for any medium or large-sized reporter to correct its TIN records in response to a November receipt of the B Notice in time for the current year's mailings. In essence, the error is compounded since the B Notice is based upon the original submission due to the Service by the end of February, and does not take into consideration updated nor corrected information. To accommodate this problem, the B Notice should be mailed within established time frames which do not occur at year-end.

In addition, payers are faced with unreasonable notification timetables. For example, upon receipt of the B Notice, payers are required to institute backup withholding on withdrawals from accounts to which previously credited reportable payments have been made; and this must be done within 7 business days of receipt of the notice. Receipt is defined as the date on the notice. Such a requirement is not provided by statute and is unworkable.

In addition, within 5 business days—also an unworkable requirement—the payers are required to send to the payee a multiple-page statement so complex in appearance and content as to dwarf by comparison the complexity of the original estimated tax declaration, better known as the W-4 Form, produced by the Service in response to the Tax Reform Act of 1986.

Although the statute requires the payer to send such notice to the payee, we do not believe Congress intended the notice to be as lengthy and as complex as the one drafted by the Service.

May I continue?

Senator PRYOR. Yes, go ahead. How much more of your statement do you have, Mr. Cotter?

Mr. COTTER. About another minute, sir.

Senator PRYOR. All right, fine.

Mr. COTTER. Moreover, it makes far more sense for the Service to send such a notice since the response thereto undoubtedly would be far greater and more prompt than the one sent by a payer.

The criteria for applying information reporting penalty provisions also needs to be reconsidered. The "due diligence" standard as applied to information reporting penalties should not be applied in a strict, inflexible manner. Alternative criteria for meeting the standard need to be established.

For example, the IRS takes the position that the only way a payer may exercise due diligence for post-1983 accounts, with respect to interest or dividend returns, is to actually obtain a TIN certified as being correct by the payee. Nothing short of actually obtaining that certification is acceptable, even if withholding is immediately implemented.

Except in the relatively rare awaiting TIN situation, no other effort will do, thus requiring the payer either to refuse to open the account or to close one if it is already opened—a legal impossibility when one is dealing with life insurance.

This position is based neither on statutory language, legislative history, logic, nor common business sense. Such a requirement is particularly inappropriate when applied to life insurance contracts where, in most situations, interest is not credited to a payee's account until 2 or more years after the policy has been issued.

Certainly, an alternative standard that would both protect the Code's information matching objective and the payor's business objective can be readily devised.

Moreover, the Service needs to assume more responsibility for obtaining and determining the correctness of the payee's TIN. Imposing the burden only on the payer is unfair, inappropriate, and inefficient.

The IRS presently has the statutory authority to impose a penalty on the payees who fail to provide their TIN to the payers. The IRS should consider exercising that authority.

The due diligence regulations require payers to annually request a payee's TIN if the TIN being maintained by the payer has not been certified as correct by the payee. There is no limit to the number of such solicitations. These mailings have proved to be minimally effective in obtaining missing or uncertified TINs.

A requirement that the payer continue these mailings, in essence forever, is at the least inappropriate. Such mailings should be required for no more than 2 or, at the most, 3 years, especially in view of the Service's unused enforcement capabilities.

I have only touched on a few of the points. A number of additional concerns are covered more fully in our written statement, which has been submitted. I understand that the IRS has indicated that it intends to reissue the backup withholding regulations. I certainly hope that the issues raised by the insurance industry today are adequately dealt with in the new regulations.

Thank you, Mr. Chairman, for the opportunity to present our views. If you have any questions, I'll be pleased to answer them.

[The prepared statement of Mr. Cotter appears in the appendix.]

Senator PRYOR. Thank you very much, Mr. Cotter.

Let's go back to Craig Rhyne. I want to ask you about a particular case that you brought up. I believe you said the Nevada IRS had come in; were those penalties of $50,000 against one business?

Mr. RHYNE. Yes.

Senator PRYOR. And what has happened to that business?

Mr. RHYNE. They are still in the middle of it. They are still negotiating with the IRS; it has not been determined whether it gets out of it or not.

Senator PRYOR. What was the amount of tax due to the IRS?

Mr. RHYNE. Oh, there was none. No, everything was done accurately.

Senator PRYOR. This was a pure penalty situation for either lack of filing or filing late?

Mr. RHYNE. Right. Filing late.

Senator PRYOR. Filing late?

Mr. RHYNE. Yes.

Senator PRYOR. And the penalty was $50,000. Was that an arbitrary figure?

Mr. RHYNE. I don't know the answer to that. I can find that out for you, Mr. Chairman.

Senator PRYOR. All right. I think that might be a good story for the record.

Mr. RHYNE. Yes.

Senator PRYOR. We are trying to find some of these actual, real-life stories; and any information on that that you could disclose, we would appreciate.

I had the chance some time ago of visiting with several of the coin dealers from around the country. I found one concern expressed there to be pretty universal, and I would like to clarify this to see if it is still going on.

Is the IRS today using enforcement against your organization and the coin dealers that are in proposed regulations or regulations that have not yet been adopted? Is this still the case?

Mr. RHYNE. That is the case, and it is so confusing. The left hand doesn't know what the right hand is doing; and in one section of the country, they are using the proposed regulations. We have been promised several different times that the finals were going to come out, and they never come out.

Senator PRYOR. But still, the enforcement is based upon the proposed rather than the final regulations. Is this correct?

Mr. RHYNE. Yes, that is right.

Senator PRYOR. Legally, I don't know how IRS can do this. Maybe I am wrong.

Mr. RHYNE. There is even confusion around there because there is one of these regulations that has two different dates—1983 and 1984. One of them, I believe, was a final; and we don't know which is which. Some of them say that items covered by the Commodities

Futures Trading Commission are regulated. It is just terribly confusing.

Senator **Pryor**. Now, a 1099 form is a relatively simple form, and it doesn't require a great deal of information. Some people say that what IRS is really after is the drug launderers who are dealing in gold and silver, etcetera.

Mr. **Rhyne**. Yes.

Senator **Pryor**. Do you think this is what they are really after?

Mr. **Rhyne**. I don't think they are after that in 1099(b)s as they are in currency transaction reporting because, if a drug dealer wanted to sell his gold, we don't pay him in cash; we pay him in a check. And if wanted cash, then that would kick in at the $10,000 limit.

That is why we think the $10,000 limit is good because currency transaction reporting will allow us to catch the drug dealers. They don't want a check.

Senator **Pryor**. They want cash?

Mr. **Rhyne**. They want cash.

Senator **Pryor**. Now, you say that on a transaction over $20, you must file this form and this information. You have estimated that it costs $8 in computer time and $2 in staff time to file one of these forms. How did you arrive at that?

Mr. **Rhyne**. We took the number of transactions that we as a middle-sized firm did, which was 2,500 transactions—purchase transactions, not sell transactions—but where we are purchasing back from the public; and we divided that by the costs of the computer system and/or staff to do this.

Senator **Pryor**. I see.

Mr. **Rhyne**. Sir, on that matter, I forgot to ask that the index study where we came up with those numbers be submitted to be made a part of the record.

Senator **Pryor**. That will be a constructive part of the record, and it will be printed at the appropriate place in the record.

Mr. **Rhyne**. All right.

Senator **Pryor**. We appreciate that.

Mr. **Rhyne**. So, our study and then the Moss Adams study that addresses it and makes it complete. We would include the Moss Adams study also.

Senator **Pryor**. Right.

[The information appears in the appendix.]

Senator **Pryor**. I may come back in just a moment, Mr. Rhyne, for another question or two. Let me address Mr. Ruempler for one or two questions. You talked about the penalties that are being today imposed on banks. We have talked a great deal this morning about third party penalties for providing incorrect taxpayers 'identification numbers.

Do you have any suggestion in your statement or testimony or from the association you represent on what we might do here to make the system simpler and fairer?

Mr. **Ruempler**. I think the principal suggestion we would like to make is that, if the bank has submitted a TIN which it has obtained from its customer and has a W-9 to go with it—that is, a form that has been signed by the customer that says that is the proper number—when the IRS determines it is a mismatch, if the

IRS still disagrees, rather than continuing to impose a penalty on the bank for having a number that doesn't match with the Social Security record, the IRS should go to the taxpayer directly.

In that way, if there is some misunderstanding—if somebody has changed their name; if a number has been transposed along the way—it can be dealt with directly.

Senator PRYOR. Yes.

Mr. RUEMPLER. We are a middle man who cannot ultimately confirm or verify the number.

Senator PRYOR. There is no study on time and resources, effort, dollars expended in complying with these IRS regulations from the banking industry, is there?

Mr. RUEMPLER. Some individual banks have compiled numbers. We have not been able to aggregate those because everybody will make those determinations separately about whether to include certain costs. I think that it is a reasonable estimate that, since 1983 when the backup withholding and the TIN matching program was changed, the commercial banking industry has spent roughly $1 billion over that 5-year period.

Senator PRYOR. Over $1 billion?

Mr. RUEMPLER. Yes, sir.

Senator PRYOR. While I don't want to take the side of the IRS, I do know that they think they can go to the third party here in the case of the banks where you do have computers and better records than many times that individual has; but once again, the records that you have are only as good as the information you get from that individual and from your customers for whom you have to furnish the information. I understand that.

Mr. RUEMPLER. It is a little difficult when the customer comes back the second time and says: No, that is my correct number. The bank then submits another information return and gets another $50 penalty.

Senator PRYOR. We had a little company that came in recently that the IRS had decided, after 56 years of being in business, that this company's name was not what it was supposed to be. (Laughter)

And so, they started sending it notices under another name; and finally, they took the local telephone directory and they took witnesses to the IRS and put on a little mini hearing and said, yes, this is us. They told them they had been sending notices to the wrong company.

Finally, Mr. Cotter, let me ask you this. Have you done any studies at the ACLI on time and resources required to comply with the IRS regulations?

Mr. COTTER. In reference to the due diligence backup withholding issues?

Senator PRYOR. Yes.

Mr. COTTER. Sir, I don't have those figures with me. I know with my own company that the cost has been quite substantial, and it continues to be substantial in reference to trying to remain in compliance, both on the system modifications and the annual notice process, and trying to determine exactly what the Service is seeking to have us do.

It was just mentioned that you had been advised by a taxpayer that the number is correct; we have run into the same thing, sir. And we have found and we believe in some circumstances, that our records are more accurate than those of the IRS, especially when it involves name changes and things of that nature.

Again, the likelihood of someone advising us when we are making a payment to that individual of that name change is more probable than their advising the Social Security Administration, where they may not be receiving a benefit for X number of years into the future, especially where marriage or divorce is concerned.

Again, a lot of these mismatches are based upon that Social Security Number, that TIN, and that name. In addition, we have also placed edits in our systems, and I know that a lot of insurance companies have done this and the banks have done the same, in reference to trying to capture incorrect TINs prior to their entering our records—our files.

We have sought from the Service—from both the Social Security Administration and the IRS—a means of identifying potentially incorrect TINs, in reference to sequence or series of numbers. I believe that the last notice that was issued by the IRS was back in 1983, and we have determined that to be inaccurate, based upon feedback that we have received from taxpayers, who have sent us their Social Security cards.

Again, it puts us in a very awkward position, both in reference to being exposed to those penalties and also to the services that we have to provide to our policy-holders, our customers.

Senator PRYOR. Thank you, Mr. Cotter. I have just one more question for Mr. Rhyne. In your study that we are submitting for the record from your group, do we have in that study anything that deals with the variation or application of penalties in one area of the country versus another?

Mr. RHYNE. No.

Senator PRYOR. If there is anything you might obtain from your organization members, I think that would be very beneficial because a major thrust of this hearing this morning has been addressed to the various applications by the Internal Revenue Service in separate regions of the country.

Mr. RHYNE. All right.

Senator PRYOR. This may be hard information, but whatever you have at your disposal would be most helpful, I think, to this subcommittee and ultimately to the Congress. Of course, there is nothing more we can do on this issue in 1988; but 1989 is a new year. We start off with a new Congress. All legislation expires; it dies on the calendar. And come January, the Lord willing, the 101st Congress will convene; and at that time, we are going to make a major effort to look at the penalty area and to a large degree at the inequity issue and the penalty issues that have been growing in the past several years.

I think this hearing has been very good this morning. I want to thank not only this panel. We want to especially thank our task force members who have traveled many, many miles to be here today.

Let me say that Mr. Allen, who could not be here with us today—from Texas, I believe—

Mr. **Ruempler**. North Carolina.

Senator **Pryor**. North Carolina. He is a member of our task force, and he has served very well; and we are very, very appreciative of his membership on the task force. I want to thank you, and this meeting is now concluded.

[Whereupon, at 11:50 a.m., the hearing was concluded.]

APPENDIX

ALPHABETICAL LIST AND MATERIAL SUBMITTED

Testimony of the American Bankers Association
before the Senate
Subcommittee on Private Retirement Plans and
Oversight of the Internal Revenue Service
September 28, 1988

Mr. Chairman and Members of the Subcommittee, I am Jonathan W. Allen, Senior Vice President and Director of Taxes, First Wachovia Corp., Winston Salem, North Carolina. I am appearing today on behalf of the American Bankers Association ("ABA") and presently serve as a member of the ABA Taxation Committee and chairman of its subcommittee on Tax Compliance. The American Bankers Association is the national trade and professional association for America's commercial banks of all sizes and types. Assets of ABA member banks are about 95 percent of the industry total.

The Subcommittee's action to review the Internal Revenue Service ("IRS") implementation of the penalty provisions of the tax code is as important as it is timely. Similar action is also underway by your counterparts on the House Ways and Means Committee, where I testified in July. Efforts are also being made by the Tax Section of the American Bar Association and, perhaps most encouragingly, by an advisory group to the IRS Commissioner. All of these efforts reflect the fact that IRS penalty provisions have become too numerous and confusing and, in many cases, are not implemented in a fair and equitable manner.

My testimony this morning will be directed primarily at the IRS penalty provisions concerning information reporting, taxpayer identification number ("TIN") matching, and backup withholding. I would also like to make a brief comment about the enactment of penalties; in specific, the retroactivity of penalty rates.

The IRS received nearly one billion information returns last year, with hundreds of millions of those being filed by financial institutions, on all types of interest bearing deposit accounts, mortgage interest payment accounts, broker transactions where the bank plays a role as middleman for a transaction between two customers, and many other types of transactions. Thus, commercial banks are in a position to be very familiar with the IRS' implementation of the penalty provisions related to information reporting and backup withholding.

Mr. Chairman, some people may recall the lobbying by information reporters and their customers in 1982-1983 against mandatory withholding on deposits and conclude that we have no room to complain now about the implementation of the alternative system. The commercial banking industry recognizes the importance of IRS and Congressional efforts to close the tax compliance gap through the TIN matching program and backup withholding. Indeed, the commercial banking industry has done as much as any group to further the effort to have a clean system of TINs and to provide to the IRS information that would enable them to track down tax cheats. Banks all over the country have made annual "due diligence" mailings to customers seeking certified TINs, revised their computer systems to implement backup withholding, trained personnel about how the IRS rules affect procedures for opening accounts and handling window transactions, tracked down apparent incorrect TINs in response to IRS "B" notices (TIN does not match social security records) and "C" notices (customer has underreported interest and dividends), etc. The vast amount of monetary and human resources expended by the commercial banking industry has significantly benefited the IRS in identifying and collecting additional tax revenues. The industry's effort has been carried out under a continuingly changing set of IRS temporary rules issued in fragmented question and answer form over the past five years. It is only this year that the IRS would say that at least a temporary set of all the regulations are now published.

The IRS' implementation of the TIN matching program and the backup withholding system has been perceived by information reporters, however, as arbitrary and divorced from reality. Penalties applied in cases where banks have made an enormous effort to comply with the law appear unfair. Indeed, the system seems to be overrun with penalties. Take for example the penalties that might be applied on the bank in connection with a simple savings account.

* Failure to file with customer - $50/return, no maximum.
* Failure to file with IRS - $50/return, no maximum.
* Failure to timely file with the customer - $50/return, no maximum.
* Failure to provide a correct taxpayer identification number on 1099 sent to IRS - $50/return, no maximum.
* Failure to provide a correct taxpayer identification number on 1099 sent to customer - $50/return, no maximum.

- Failure to provide correct information to IRS - $5/return, no maximum.
- Failure to provide correct information to customer - $5/return, no maximum.
- Failure to file on magnetic media - $50/return, no maximum.
- Failure to file on machine-readable forms - $50 per return, no maximum.
- Failure of a broker to provide the notice to payor regarding backup withholding - $500/occurrence.
- Failure to backup withhold - the amount that should have been withheld.
- Failure to deposit taxes withheld - 10% of the underpayment.
- Intentional disregard of the requirement for filing information returns - the greater of $100 or 10% of the interest required to be reported.

In addition, interest accrues on outstanding but unpaid penalties at the prescribed rate.

The implementation and enforcement of these penalties are egregious. The IRS imposes penalties on banks for failing to provide information that only the customer can provide or verify. The IRS needs to recognize that there are limitations on a bank's ability to obtain TINs from customers. The September 1988 GAO report on the "Accuracy of Taxpayer Identification Numbers on Information Returns" states that "we agree with payors that they should not be asked to serve as enforcement agents for resolving incorrect TINs resulting from circumstances beyond their control, such as name changes that were not provided to social security". (See p. 24 of GAO Report, No. 88-7426). Congress has provided the IRS with the authority to apply a penalty upon a customer when he fails to provide a TIN or provides an incorrect TIN; but so far it appears that the IRS has failed to exercise that authority with the diligence it uses in monitoring the banks. Direct contact with the taxpayer would be more effective in getting correct TINs; however, the IRS finds it easier to levy a penalty on the bank rather than further the objective of a voluntary compliance system by getting the necessary information directly from the taxpayer/customer.

Penalties are applied by the IRS for incorrect TINs where the bank failed to perform "due diligence" to the "nth" degree. For example, a large bank with hundreds of branches undertook all of the separate mailings, revised all of its computers, trained personnel about new procedures for opening accounts, etc. at a cost of several million dollars. It discovered however, that at one office for a period of about six weeks, new accounts were opened without obtaining the requisite W-9 form. As a result, the responsible bank officer could not certify, under the penalty of perjury, that due diligence was performed on every account, although clearly a system-wide compliance had been achieved. Nonetheless, the IRS applied a $500,000 penalty on the bank for missing or incorrect TINs. Surely there should be some recognition for substantial compliance. Due to the number of returns required, a constantly changing customer data base, the seemingly continuous changes to the tax laws and regulations, and the human factor, returns will be filed with inaccurate information. This, however, should not be considered an indication that the failure to include correct information is due to any intentional disregard of the correct information reporting requirements. Currently, the IRS holds information reporters to a "zero tolerance" level. This is unfair and inequitable.

The ABA recommends that the IRS consider all the facts when determining whether commercial banks exercised due diligence under the temporary backup withholding regulations. Employees for the banking industry are human and as such, errors will occur. Thus, no reporting system can reasonably be expected to function error-free. As the IRS Task Force for the Commissioner's Penalty report states, penalties should not be a mechanism of first resort in achieving compliance on information reporting. In the GAO's study, the IRS also expressed the positions that (1) payors are IRS' partners in making the tax administration system work; (2) it is in the government's interest to work with payors to encourage long-term compliance with the rules surrounding information returns; and (3) penalties should not be a first resort in achieving compliance if a payor is "sincerely trying to comply and has instituted reasonable business practices to assure compliance." (See p. 21-22 of GAO Report, No. 88-7426) Penalties imposed on taxpayers making every effort to comply blur the distinction between compliant behavior and non-compliant behavior. It is very discouraging to be penalized when you have made best efforts to comply, but often the penalty appears to be inevitable. If a payor is trying to comply and has instituted reasonable business practices to assure compliance, penalties are not appropriate. Therefore, the ABA recommends that the IRS revise its penalty structure to incorporate a qualitative "substantially complied" standard for filers of informations returns.

Additionally, I would like to bring to your attention a totally unprecedented retroactive increase in the penalty rates applicable to late deposits of withheld taxes that was added to the Code by the Omnibus Budget Reconciliation Act of 1986. This provision doubles the previous penalty for late payment of withholding tax deposits from 5% to 10% for all penalties assessed after October 21, 1986, and without regard to the tax years for which they were imposed. Unless the "reasonable cause" exception applies, the penalty is due if the deposit is as much as one day late. Yet, the penalty amount (10% of the overdue balance) is the same whether the deposit is one day late or several months late. Moreover, this penalty is in addition to the interest customarily imposed on late payments. The statute of limitations and the interplay of IRS audit practices further aggravate this situation. The normal three year statute of limitations on assessments of taxes and penalties should be sufficient time for the IRS to audit a tax return and for an information reporter to exercise his rights to administrative review--however, this is usually not the case. As a matter of course, IRS auditors request extensions of statutes of limitations, and information reporters have no choice but to sign them if they wish to exercise their administrative review rights before a tax or penalty is assessed and paid. It is not unusual (particularly in the case of large corporations filing complex returns) for more than five years to elapse between the date a tax return is filed and the date on which the tax or penalty is actually assessed. If the penalty is assessed after October 21, 1986, the 10% rate applies no matter how long before that date the tax return was filed. The retroactive increase in the penalty rate is especially onerous in situations where the taxpayer already made the required deposit before the assessment is prepared by the IRS.

At this time, I would like to make recommendations that reflect the banking industry's desire to work with Congress, the IRS and taxpayers to create an information reporting system that is fair and equitable. Specifically, the ABA recommends:

*Establish a qualitative "substantially complied" standard for information reporters in lieu of the current "zero error" tolerance level.

*Create an IRS Information Reporting Task Force to meet quarterly with the industries that are the principal information reporters for the purpose of reviewing, at a policy level, the implementation and administration of the information reporting program. Consistent with the Government in the Sunshine Act, these meetings should be open to the public with regular minutes taken, and results of the meeting published.

*Direct the IRS to use the authority given to them, by Congress, to pursue taxpayers who have failed to provide accurate and certified TINs. This is a more effective way to go after those taxpayers who have been unwilling to comply with the TIN program. The due diligence responsibility of information reporters should be limited to two annual mailings requiring W-9 certification; although, information reporters would still be required to backup withhold on these taxpayers' accounts.

*Require all changes in IRS information reporting regulations and requirements to be issued prior to October 1 of the preceding tax year so that information reporters have ample time to implement the changes as well as educate their personnel. In a related matter, any information reporting regulations that the IRS issues must be in proposed form with an accompanying comment period. Temporary regulations should have a mandated life span of one year--after which they will be considered proposed (with a comment period) unless they are issued in final form within one year.

*Require the IRS to use the name and address on the transmitter file as the contact address for IRS' mailings to information reporters. The IRS' current use of the information reporters address from income tax and other returns delays the ability of information reporters to comply with IRS' requests.

*Centralize IRS information return processing at a single service center. This would facilitate the IRS' enforcement of the TIN program as well as improve the IRS' responses to questions from information reporters and taxpayers.

*Enact legislation that would designate the effective date of the 10% rate to deposits which were required to be made subsequent to October 21, 1986.

On behalf of the ABA, I appreciate the opportunity to comment on information reporting penalties. The ABA is willing to work with the Subcommittee in addressing this important issue.

STATEMENT OF
PATRICIA BURTON, EA
BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND
OVERSIGHT OF THE INTERNAL REVENUE SERVICE
OF THE

SENATE FINANCE COMMITTEE

September 28, 1988

Mr. Chairman and Members of the Committee:

My name is Patricia Burton. I am an Enrolled Agent and a partner in the Gales Ferry Tax Service, Gales Ferry, Ct. I am Past President of the National Association of Enrolled Agents and represent NAEA on the Private Sector Penalty Task Force. I am here today, however, at the request of the Committee solely in my capacity as a tax practitioner. I appreciate the opportunity to appear before you today

I am somewhat awed by the company in which I find myself, not because of any false sense of inferiority, but because I certainly can not offer the credentials that have so distinguished these panels today and over the past few months. I have however read the majority of the statements and believe that the perspective I can bring may provide some additional insight to guide you in your deliberations.

I am a taxpayer turned preparer and then practitioner. I do not believe preparer and practitioner are interchangeable terms. A practitioner as defined in Treasury Circular 230 is "an attorney, a certified public accountant, enrolled agent or other person authorized to practice before the Internal Revenue Service." I believe practitioners should be held to a higher standard of accountability as indeed we are under 230.

In 1968, I enrolled in the basic taxation course offered by H & R Block because our own taxes had begun to seem complicated. I found the course fascinating and decided to accept employment as a preparer. Like many who complete what is known as "Block basic", I thought I knew all there was to know about taxes. I learned otherwise upon confronting my first client. Between that first season as a preparer in 1969 and this day, I have never felt so woefully inadequate to cope with a tax season as I felt this year.

I worked seasonally from 1972 until 1977 when I felt I wanted to provide a different kind of service to taxpayers. In 1977, I opened my own office, sat for and passed the Internal Revenue Service Special Enrollment, and was enrolled to practice before the IRS in 1978. I still view my enrollment card as my most significant professional accomplishment.

We have about 550-600 clients - individuals, small partnerships and sole proprietors. When I say "small business," I am speaking of gross receipts of under $300,000 as opposed to the Service's definition which I believe is under $5,000,000. We do no corporation returns, partly because we find accounting per se a rather dull and repetitious occupation, but also because we believe that many small businesses function better in the non-corporate form. The tax laws for corporations are complex and the correct preparation of corporate returns is, in my opinion, a specialty in itself.

Our practice is built on the idea that it is the taxpayer's money that is involved, the taxpayer who must pay the tax, and the taxpayer who must understand the tax implications of what he or she does before it is done. When I started in taxes, the Code was complex, the timing of events was important and planning a nice service to offer clients. Today, the Code borders on the incomprehensible, timing is crucial and planning imperative. And all too often, the most carefully conceived and implemented plans go for naught because of what taxpayers see as capricious changes to the rules they were playing by.

The specificity in the Code is awesome. Many of the regulations are so convoluted that they would be material for outstanding comedic routines in the hands of the right talent. They appear to be, by and large, written by attorneys for the guidance of other attorneys. In the last two or three years, a number of Q & A regulations have been published which have not been well received by segments of the practitioner community. (I for one appreciate them.

I can copy them and give to my clients with some conviction that they will be read and understood.)

According to the Commissioner's Annual Report for 1987, there were 101,750,800 individual tax returns filed in CY 1986. Of these 30,258,600 reported Total Positive Income of under $10,000; there were 30,993,100 returns showing TPI of $10,000-$25,000 and 23,810,500 returns showing TPI $25,000-$50,000. There were 1,903,000 returns with a Schedule C showing Total Gross Receipts under $25,000 and there were 240,000 returns with a Schedule F showing TGR under $25,000. If one makes the assumption in the absence of specific information that the C and F filers with TGR under $25,000 fall into the TPI category of under $50,000, there were 87,170,000 taxpayers who reported total annual income of under $50,000. That is 85.67 percent of the total individual returns filed and 79.57 percent of the total individual, corporate, fiduciary, estate and gift tax returns filed that year. We have no clients in the under $10,000 TPI except for some dependent children, a few in the under $25,000 and the balance split about evenly in the under/over $50,000.

In June of 1987, the results of the IRS Survey of Tax Practitioners and Advisors was released. In that report, it was stated that approximately 40,000,000 taxpayers a year pay someone to fill out their tax forms. In other words, over 60,000,000 taxpayers a year do it themselves. Based on the experience of our practice, it seems reasonable to assume that the vast bulk of these do-it-yourselfers are in the first two categories cited above.

Mr. Chairman, in spite of all that you have heard to the contrary, these taxpayers are trying to do it right. It is my opinion that not one in 10 but fewer than 1 in 100 taxpayers consciously omits income, evades taxes, "cheats." The others are doing their best to understand the law and abide by it.

They also seek to mimimize their tax burden. They read and believe vast quantities of misinformation in the media - not conscious distortion but careless interpretation of the rules stated with authority. They receive misinformation from the Internal Revenue Service. Once again, it is normally careless interpretation of the rules stated with authority. Nothing is more difficult for someone like me to do than to change the mind of a taxpayer who has been given the wrong answer by an IRS taxpayer assistance person, especially if that answer is the one the taxpayer wanted to hear. The problem is seldom that the answer is really wrong but that it is wrong given the facts and circumstances of that individual's case. (I am not denigrating the taxpayer assistance efforts of the Service. To the contrary, I applaud them. I do suggest that more direction should be given to personnel in that area, that pertinent publications should be identified and quoted, that if the taxpayer assistant can't tell the taxpayer where to verify that something is the correct answer, the answer shouldn't be given.)

You have heard testimony about the difficulty of reading the instructions that come with the forms. Form 1040 for 1987 has 20+ pages of instructions on preparing the basic form before any instructions are given on preparing the Schedules. In those 20+ pages there are more than 30 references to other Publications "for more information" on how to treat specific items. Given the admitted difficulty in acquiring the knowledge one needs to complete even the simplest Form 1040, it is hardly surprising that taxpayers make mistakes, misunderstand the directions, understate AND overstate their liabilities.

Then there are those taxpayers who are overwhelmed by the whole effort and don't file on time. Over the years we've been in practice, several dozen taxpayers have come in not having filed one, two, three, even six consecutive years. In every case, the first year's reason was rational, perhaps abateable. But the subsequent years were the result of fear. It is my experience that taxpayer fear of the Internal Revenue Service is largely undeserved. But taxpayers have enough evidence to justify those fears that combatting them is difficult.

Only three of these procrastinators sought help because the Service had noted their failure to file and came after them. The rest simply decided to face the music because they didn't like being out of step with society. Oddly enough, the majority had no liability because their withholding had been adequate to cover their taxes. Many were filing so late that they were not entitled to their refunds under the law. They find it hard to believe this because they know that had they owed for the same period, the taxes would still be due with penalty and interest.

Thanks to document matching, this is not apt to to happen so often in the future. More and more, the Service is advising taxpayers in a timely manner that no return is on file.

The saddest cases are those who didn't file on time because they didn't have the money to pay the tax. I believe the one of the biggest educational failures of our system is that the majority of taxpayers don't understand the difference between the penalty for not filing on time and the penalty for not paying on time. In fact they don't understand that you CAN file a return without payment. Inevitably these people are self-employed. There has been no withholding to cushion the blow. When reality sets in and they decide for themselves to face up to the problem or the IRS has become aware that no return was filed and sought them out, the combined income and self-employment taxes with the penalties and interest added are incredible. Sometimes there are sufficient assets to enable them to pay in a reasonable time. Other times, they lose their homes and anything else they might have and still owe taxes.

Mr. Chairman, the people I am talking about are not tax cheaters. For one reason or another, they have run afoul of the system. Most of these people have gotten themselves into trouble because taxes have become so complicated that they realized they couldn't figure it out themselves and it was too late to get help, or they had financial problems, knew they owed and they had no money. In other words, April 15th came and they couldn't cope with it.

Taxpayers who themselves would not deliberately cheat on their taxes are not scornful of their friends who get into trouble with taxes. They see people who are in trouble with the IRS as victims.

These same taxpayers unthinkingly contribute to the underground economy. They pay cash to others who won't accept checks, do not insist on withholding Social Security taxes from household employees, even forgo legitimate deductions if claiming them "will get so-and-so in trouble." They don't understand that this IS the underground economy; they just know they can't get household help any other way, or the individual was on strike and needed the money for food, or the person was on welfare and would lose his benefits. True or false, this is what they believe. They are tolerant of people poorer than themselves cutting corners because they think the system is unfair.

And they do think the system is unfair. They believe the tax laws are structured to favor the very wealthy. They understand that they can't deduct interest on financing their cars but some people can deduct the interest on two houses. That is a single example of the perceptions of taxpayers about the TRA-86. I could list dozens of examples of areas in which the taxpayers I am talking about feel that they were deluded by promises of reform and have been 'had' by the laws that were enacted. They feel this way before the spectre of penalty rears its ugly head.

If it had appeared to you that I don't know what I am here to talk today, I apologize. I know we are talking about penalties. But to understand the impact of the current penalty system, one must understand the frustration of American taxpayers. When they really believe they've done their best, being rewarded by a "presumption of negligence penalty" and "an amount equal to 50% of the interest payable under 6601" on top of whatever additional taxes and interest are involved because of their mistakes, can only reinforce them in their belief that, as you said your statement when you initiated these hearings, what has happened to them is "fundamentally unfair."

Although the "presumption of negligence" and the "50% interest on interest" are rebuttable, it is very difficult for the Service to establish satisfactory guidelines for waivers and very difficult to administer evenly the ones that are established. As a result, the average taxpayer does not get a waiver. The most logical reasons in the world have been denied. It is possible to pursue the question but too many taxpayers just pay it because it is too time-consuming to fight. The testimony of H. Christopher Moss before the House Subcommittee on Oversight is indicative of the problem. In the 10 months that he was seeking a waiver, the liability grew over $500 and that was apparently on the penalty and interest alone since it appears that the taxpayer had paid the tax. He was speaking of late filing penalties and interest but the difficulty of securing the waiver is the same.

I would urge an automatic abatement of presumptive negligence penalty for first offenders. I was dismayed to read the comments of Richard Stark, Assistant to the Commissioner, as they were quoted in the Wall Street Journal "Tax Report" column last week. According to the article, because the IRS would not know "whether a slip is your first - or just the first one caught," Mr. Stark felt the problems of structuring relief "may preclude general waivers for individuals." That is a hard pill to swallow when the candidates for "broad relief" are those corporations "where the IRS has regular accounting relationships with firms and seeks incentives for correct filing." It is all part of the message that comes from Washington - not only from the IRS, Mr. Chairman, but from Congress as well - that taxpayers whose returns are less than perfect were "playing the audit lottery," "are trying to get away with something," are "tax cheaters." The implication of the phrase "the first one caught" is that whatever the error was is was deliberate.

In that same column, a vice-president of the Weyerhauser Co., Neil Wissing, is quoted as having told the Commissioner's Advisory Group that the company's 40-man staff spent 75% more time on their return and "Nobody is sure it's accurate..." Mr. Wissing is not alone. I doubt there is a responsible practitioner or preparer in the country who is certain that all the returns they prepared were without error.

The present system relating to unpaid taxes offers no incentive to come to grips with one's problems. Unless payment is made in full, the penalty continues to grow, the interest continues to grow, and now the interest on interest continues to grow. In 1986, I was working on trying to get one of my clients at least started on the right track, I received some figures of current status of the client's account from her Collection Officer. At that time she owed $34,423 for three years of taxes and $14,669.34 in penalties and interest. The monthly increase in her liability was $473.82 interest and $172.12 in penalties. This is a self-employed single parent, working on commissions, with 3 teen-age children, who owned her own home which has subsequently been sold at public auction. She had equity in her home but she was unable to get it out because she could not demonstrate the ability to pay larger mortgage than she had. At this stage in the game, it is immaterial that she brought it on herself. What is material is that had she been able to afford to commit to an installment payment of $650 a month, she would only stay current with her obligation. We had not gone to interest on interest at that time.

There needs to be a stimulus to taxpayers to get on track. I am not objecting to the penalties on failure to file and/or failure to pay. But during the course of trying to pay off the tax liability they can equal 50% of the tax. It is enough. Nor do I oppose interest on the outstanding tax liability. But let interest on penalties and interest on interest stop the day the taxpayer takes steps to deal with his problem.

We need to allow taxpayers to file extensions without payment. The extension provisions are of no use to those people who can neither complete a return or pay an estimated liability on April 15. They would still be subject to the 1/2 of 1% for not paying on time and the interest on the unpaid balance of the tax but they would have a real incentive for getting the tax return filed in a timely manner.

The information return penalties and the deposit penalties have been addressed eloquently and at length by many others in these hearings. However, I would like to talk about them as they apply to my clients and to those taxpayers who are still trying to do it themselves. There is an incredible inconsistency in the fact that a penalty is the same whether one files late or one fails to file. It is probably one area where many small taxpayers do "take their chances." Many of my small partnerships and sole proprietors do their own books. When I see their information, it is often March. They are already late. If a small contractor who has 15 subcontractors is going to get a $50 penalty for each failure to file Form 1099 on time and the same $50 penalty for each failure to file at all if he is "caught," to quote Mr. Stark again, it is not difficult to understand the temptation not to file at all. It is easier to make this kind of error having to do with 1099s if one is in business and uses subcontractors for the first time. Sole proprietors don't need an Employer Identification Number for subcontractors. They use their social security numbers. They may not know about reporting until they bring their records to a preparer or if they do their own taxes when they read the instructions. How much better it would be if sole proprietors and farmers merely attached 1099s to the first return which involved any NEC expense. They may be late getting the information to the recipients but my experience has been that the recipients not only know what has been paid but report it. The taxpayer could then receive a simplified version of instructions for 1099s which alerted them to the rules for the future.

The instructions for 1099s and Circular E, the Employer's Ta Guide, for W-2s are even more difficult to read and understand than those for individuals. The same instructions go to General Motors as go to the owner of the Main Street Grocery Store. Circular E is 55 pages long and discusses fringe benefits, golden parachute payments, magnetic media filing, Federal, State and local government rules, Federal Tax Deposit rules, and more. They have been written for the 40 people on Mr. Wissing's staff.

I have a client who paid more than $1400 in penalties last year on federal tax deposits (on a staff of two full time and 2 part time people) before he gave up and asked us to compute the deposits and due dates. Each one of those penalties was on a first time offense - in other words each mistake violated a different rule.

I have tried to address myself to the problem as it affects the individual taxpayers. Most of the time the amounts are not significant which does not make the penalties fair, however.

But with TRA-86, I fear that many penalties which have not previously been a problem for small taxpayers and many penalties which have not previously been a problem for preparers may well prove significant in the future. The first installment of the regulations under the new passive income/loss rules came out in March of 1988 - all 55 pages of them. I had heard they were longer but that is all I received from my tax services. Diligent application of those regulations is apt to produce any number of taxpayers who have "substantially understated" their liability. The Section 6661 is perhaps the most onerous penalty on the books because it is "no fault." In a democratic society "no fault penalty" seems a contradiction in terms.

The so-called "safe harbors" of disclosure and/or "substantial authority" provide no protection for the average taxpayer and the average small preparer and practitioner. How can people disclose what they don't know is wrong. Although we subscribe to two major tax services and a forms service, I was not aware until this month that there IS a form for disclosure. It is not listed in Pub 1045 - the publication preparers and practitioners use to order forms, etc. Having found it, I am not sure I would know how to use it.

If a taxpayer is found to have a "hobby loss" instead of a business, will his belief that it was a business be a "safe harbor?" If a taxpayer is found to have non-deductible passive losses because he failed the "material participation" test, will the fact that he didn't understand the rules be a "safe harbor?" Will the fact that the taxpayer never heard the terms "disclosure," "material participation," "safe harbor" be a "safe harbor?"

The Congress gave some guidelines as to "substantial authority" which the Service adopted in toto in the 6661 regulations. Since this a very grey area, in the final analysis it will be determined by the Courts. I can't go to Court. CPAs can't go to Court. EAs have tried for four years to get legislation that would enable us to represent taxpayers before the Tax Court and failed. One can hardly send the taxpayer to represent himself pro se on such an issue. The average attorney with the tax expertise to handle this kind of issue advises "pay it" unless the amounts involved are significant indeed.

The definition of "substantial authority" includes little that is easily accessible to the small preparer and practitioner. It should expanded to include tax services from established publishers like CCH, RIA, BNA, etc., among other things. There is so much in the Code for which there are no regs, no instructions, no guidelines, that some credence should be given to whether or not the taxpayer's position made sense to the taxpayer.

You are accustomed to hearing from the top tax practitioners in the country and it is obvious that they are not in agreement about everything. The present penalty structure is aimed at taxpayers who employ these specialists, who are counseled on taking positions, and perhaps do play the "audit lottery game."

The present penalty structure punishes honest taxpayers who never heard of the "audit lottery game." I must say to you, Mr. Chairman, that these people are in the majority.

They don't understand the interaction between societal needs and revenue raising. They don't understand the distinctions among Congress, the IRS and the Courts in the implementation of tax laws. They only understand that something is wrong with the system.

"Fairness" is the theme that runs through all the testimony you have heard to date. "Fairness" is the message of the Commissioner's Executive Task Force Penalty Study.

If taxpayers have lost respect for the system, it is because the system is "fundamentally unfair."

I would like to say how much I appreciate that you are holding these hearings, and appreciate too the opporunity to speak and to serve on your Task Force. I wish more attention was being paid by the media to your efforts, and those of others including the Internal Service to face and deal with the problem. Solving it with go a long way in solving the problems of voluntary compliance and restoring taxpayer confidence in the tax system.

Statement of Alison E. Clapp, LeBoeuf, Lamb, Leiby & MacRae
New York, New York

American Bar Association, Section on Taxation
Civil Penalties Task Force

Thank you, Mr. Chairman and Subcommittee Members. I am a subcommittee chair of the Civil Penalties Task Force of the American Bar Association ("ABA") Section of Taxation. I am also a member of the Administrative Practice Committee of the ABA Section of Taxation.

I will outline the Task Force recommendations concerning the information reporting penalties.

I. THE INFORMATION REPORTING PENALTIES

Roughly one-third of the civil penalties in the Internal Revenue Code of 1986, as amended (the "Code") are imposed upon the failure to correctly and timely file various information returns. These penalties must be judged in light of the nature and function of information returns.

Most information returns are filed by third parties with whom taxpayers deal. For example, banks file Forms 1099 to report interest paid to each depositor (the taxpayer). A copy of the information return usually must be provided to the taxpayer. Some information returns are filed by the taxpayer or by the person with greatest access to information about a transaction. Examples include information returns concerning foreign personal holding companies, foreign corporations controlled by foreign persons, and U.S. persons abroad.

By matching an information return to the taxpayer return, the Internal Revenue Service (the "IRS") can detect omissions and other errors in the taxpayer return. However, successful matching depends upon correct and timely information returns. Penalties are therefore provided to induce correct and timely filing.

Information returns are crucial compliance tools. Observers including the IRS and the American Bar Association (the "ABA")[1] recognize that information reporting significantly affects the level of voluntary compliance with tax laws. Information reporting reduces the taxpayer's opportunity for noncompliance, (both actual and perceived opportunity), because the information return enables IRS to detect noncompliance. However, there are economic and social costs. The burden of information reporting typically falls upon a third party, not the taxpayer. This burden can be justified - and accepted by the reporter - only if (1) the information is needed and actually used by the IRS, (2) the reporter knows that this is so, and (3) the IRS helps the reporter to comply.

Information reporting penalties must be judged in this context. Like all penalties, they should be simple, understandable and fair.[2] Further, penalties are just one way to promote voluntary compliance with information reporting rules. The IRS also must educate reporters and help them to comply. The IRS should work with the reporting communities to develop procedures to supply needed data at acceptable cost to the reporter. The number and complexity of returns, availability of information and cost all must be considered. Thereby, reporters will know what is required, and the procedures will be suited to business realities.

The IRS recognizes the role of penalties in the information reporting area, as the recent IRS discussion draft

("A Philosophy of Civil Tax Penalties," prepared by Executive Task Force For the Commissioner's Penalty Study, Internal Revenue Service, Discussion Draft 6/8/88) states:

> "The information return system relies largely on the furnishing of accurate information by third parties. Because the tax system depends on the accuracy and timeliness of the information provided, the government should work with payors to encourage long-term compliance with these rules. The Task Force believes that penalties should not be a mechanism of first resort in achieving compliance. If a payor is trying to comply and has instituted reasonable business practices to assure compliance, penalties may not be appropriate. Rather, IRS should focus on educational efforts and other mechanisms for equipping and encouraging payors to accurately and timely provide needed information. Penalties, however, will still be an essential fixture to provide a necessary sanction for those who are otherwise unwilling to establish adequate systems, or who otherwise would choose not to comply because it would not be worth the expense to comply." (P. 20)

The ABA Task Force recommendations accord with the above. The information reporting penalties should be more simple, understandable and fair. Reporters should be able to find and understand the penalties. They should be able to identify the misconduct to which penalties apply. The penalties should be proportionate to that misconduct.

In particular, the ABA Task Force recommends that (1) an attempt be made to further standardize the information reporting penalties; (2) an incentive to correct filings or make late filings be incorporated in the penalties; (3) first-time offenders be distinguished from repeat offenders; and (4) where appropriate, the amount of the penalty vary with the amount to be reported.

II. STANDARDIZATION OF INFORMATION REPORTING PENALTIES

i. General

First, the ABA Task Force recommends that the information reporting penalties be further standardized to promote understandability.

We would note, however, that standardization is difficult. Present information reporting penalties are so diverse as to defy generalization. Thus, while Sections 6721-6724 apply to a "laundry list" of third party information returns, achieving some standardization, there remain about fifty other information reporting penalties. Some are also third-party provisions. Others apply to the taxpayer or other person most likely to have the information. Amounts vary. Methods of computation vary. Some are "time-sensitive" in that the penalty increases with the length of delinquency. Some are computed as a percentage of an amount to be reported, perhaps to approximate the "tax harm" resulting from failure to file the information return. Some are self-assessed, others are not.

Accordingly, in order to standardize, the reasons for existing diversity, if any, should be identified. Then, standardization where possible among classes and types of information reporting penalties can be attempted. Empirical data regarding utility of the information reporting requirement to which a penalty relates also would be useful. Presumably, there are at least three general approaches:

- wholesale simplification without regard to the differences in existing law, e.g., a penalty of $50 per information return, whatever the return, amount reported or purpose of reporting requirement;
- retention of existing variation but location of the penalties either with the substantive reporting provision or together in a single chapter, cross-referenced to the substantive reporting provision; or
- development of one or more prototype provisions that accommodate existing variation but in a better organized, more accessible format.

The Task Force has concentrated on the third approach, discussed below. The first approach - wholesale simplification - may not serve the goal of fairness. The reasons for existing diversity need to be examined. The chances are that, if $50 is the right penalty for violating one information reporting requirement, it will not be regarded as appropriate to another, in terms of fairness, purpose or perceived culpability.

ii. Location

Because the third approach of standardization has not yet proved feasible, the second approach becomes attractive: relocation of provisions for greater accessibility. Other commentators have suggested locating all penalties in a single chapter of the Internal Revenue Code (U.S. Chamber of Commerce, testimony for Representative Pickle's hearing 7/28/88; Tax Executives Institute, Comments on IRS Draft).

Alternatively, it may be better to locate the penalty for failing to file the information return in the provision imposing the reporting requirement. Then, the problem of defining terms for the penalty that already are defined in the information reporting provision would be avoided (a particular problem with some tailor-made penalties, e.g., section 6038(c)). There could be a cross reference provision in the penalty portion of the Code, collecting all penalty provisions.

Also, it is possible that procedural aspects such as means of contest, which may be more easily generalized than the amount, rate, or method of computation of penalties, could be located in the penalty portion of the Code. Each information reporting penalty could refer to those general procedure provisions. (It remains to be seen whether such generalization would be feasible). Cross referencing could achieve the goal of easier location of applicable penalties.

iii. Generalization and Consolidation

Generalization and consolidation are, as indicated, difficult. The Task Force has attempted generalization but has not yet been able to design a prototype that can accommodate existing variations or to develop a rationale for dispensing with variations.

The starting point for such efforts is sections 6721-6724. These provisions apply to a "laundry list" of third-party returns. They adopt a flat rate of $50, subject to an annual cap of $100,000, for failure to file the return. The rate and cap are the same for failure to supply a taxpayer copy. However, where the failure is intentional, the rate is $100 and no cap applies. Under certain exceptions, the penalty is computed as a percentage of the amount that should have been reported. Thus, the penalty for failure to report cash transactions that exceed

$10,000 is 10 percent of the amount that should have been reported. Also, a penalty for failure to include correct information in the information return or taxpayer copy is provided, at a rate of $5 per return or copy, subject to an annual cap of $20,000. If the failure is due to intentional disregard, no cap applies.

To further standardize, first, the information reporting penalties might be classified into like groups, for example: (1) third-party reporting penalties that are not included in the existing "laundry list" provisions of sections 6721-6724; (2) penalties for information returns concerning the reporter's own affairs (for short, "taxpayer" penalties); and (3) penalties for willful failures.

Then, existing law must be examined. Usually, the penalties which include a "tax harm" type measure involve returns concerning the reporter's own affairs. Presumably, such a measure is justified in such cases since the reporter may have knowledge of the "tax harm" that may result from a failure to file, and the failure to file may be motivated by a tax avoidance purpose. However, not every penalty for an information return concerning the reporter's own affairs has a "tax harm" measure. Many have a flat dollar amount. Some phase in the dollar amount over particular time periods and, so, are "time-sensitive."

Also, there are several penalties which relate to pension plans, trust and exempt organizations. For the present, the Task Force has classified them among penalties for returns concerning the reporter's own affairs. In general, the returns required of these organizations provide information to the Secretary concerning the exempt status of the organization and concerning the tax status of participants or recipients of distributions in certain situations. Thus, the returns actually have both a "third-party" and a "taxpayer" information return aspect. Also, these penalties are relatively substantial in amount and have "time-sensitive" aspects. Often they are calculated on a "per participant" basis. Also, penalties are imposed upon the organization managers responsible for the failure to satisfy the information reporting requirement. Usually, there is a maximum amount for aggregate penalties against all managers with respect to a particular failure.

Then, the next step might be to design new provisions for those penalties which have a "tax harm" measure, that is, are measured as a percentage (sometimes time-sensitive) of an "applicable penalty base," such as the amount of money or property transferred to a foreign trust, the amount of gain realized on an exchange involving a transfer to a foreign corporation, or the amount of the deficiency resulting from a redetermination of foreign tax. There also needs to be an "applicable penalty cap" in some instances, if the features of existing penalties are to be preserved and accommodated.

Thereafter, a new set of provisions could be designed to cover penalties for returns concerning the reporter's own affairs that have a flat dollar amount, with or without time-sensitivity. The problem encountered here is that there is virtually no consistency in amount. Moreover, after examining the existing provisions and the related information reporting provisions, it does not appear advisable to arbitrarily change the amount or "time-sensitivity" of the penalty.

Such changes, it seems to us, should be made, only after it is determined (1) why and when the IRS needs the information involved; (2) whether the existing penalty is applied and whether it is abated frequently; and (3) how important to reporter attitude greater consistency would be. Legislative history does not shed much light on the choice of particular rates for penalties.

In the area of third-party reporting, a penalty should be that amount needed to cause the reporter to comply (as an economic matter). In the area of information returns concerning the reporter's own affairs, an area closer to the self-assessment duty itself, perhaps a higher penalty can be justified, but still the main purpose should be to motivate the desired reporting. It is not clear absent empirical data what the "magic" amount is in a given situation, and the situations covered by the penalty provisions dealt with here (concerning the reporter's own affairs) are so divergent as to defy generalization.

Accordingly, in designing a general provision, it may be appropriate to rather arbitrarily select a generally applicable penalty amount, but provide that, instead, if higher, an "applicable penalty amount" would apply. The "applicable penalty amount" would vary depending upon the information return involved. Various peculiarities of existing law would require rather detailed special rules or exceptions even to this skeletal structure, unless these refinements are to be discarded without any particular reason other than consistency and simplicity.

A separate group of provisions could be designed to consolidate penalties concerning pensions plans, trusts and exempt organizations because, under existing law, these penalties have peculiar (and valuable) characteristics relating to the "per participant" and "numerous manager" circumstances to which they apply. It may be possible to include the partnership return (which is an information return) in this category, too, since the computation of the penalty is on a per partner basis.

Finally, some more of the third-party penalties might be included in the existing sections 6721-6724 or another third-party scheme developed to accommodate variation. At any rate, section 6676 (relating to failure to supply identifying numbers) may properly remain separate.

Also, the willful penalties perhaps should be handled separately.

The tasks outlined above are time consuming. It seems to us that it may be premature to attempt what amounts to simply a rewriting of existing provisions until we have concluded that such consolidation, alone, would be beneficial.

iv. Imposition and Waiver or Abatement Criteria

Even if far-reaching standardization is not achieved, the standards for imposition and waiver or abatement of information reporting penalties should be standardized.

At present, the abatement standards are not uniform. Generally, penalties are abated if the failure to comply is due to reasonable cause and not willful neglect. However, for interest and dividend returns, the standard is "due diligence". "Reasonable cause" and "due diligence" would not appear to be very different in application.

However, the "due diligence" standard was designed to impose a higher standard for interest and dividend returns than applies for other information returns. Presumably, it was a response to the rejection of the proposal to withhold tax on interest and dividends. Elaborate regulations interpret "due diligence", carrying out the more stringent approach taken by the statute regarding interest and dividend returns. These regulations appear to many to be inflexible, at least in application.

We believe that the waiver or abatement standards should be reviewed to determine whether the IRS presently has adequate discretion to apply these standards with appropriate flexibility and reasonableness. For example, application of penalties in cases of so-called pre-1984 accounts appears to lack appropriate flexibility. For these accounts, interest and dividend payors were required to make a "separate mailing" soliciting taxpayer identification numbers prior to December 31, 1983. Some payors failed to do so. Many did so shortly after December 31, 1983, in mailings that complied thoroughly with the "separate mailing" requirements. However, under IRS penalty policy, this untimely separate mailing does not excuse the failure to make a separate mailing by December 31, 1983. Indeed, penalties apply to every year following December, 1983 for which the account remained open.

Only recently has the IRS relaxed this policy somewhat. The latest temporary regulations provide for waiver of penalties for 1988 and thereafter, if a separate mailing occurred between December 31, 1983 and June 30, 1988. However, even now, the IRS is unwilling to abate penalties for the years between 1983 and 1988. This seems to be an extreme case of the inability to correct an error. If the IRS needs and can use information, though untimely, it seems extreme to apply the rules in this manner. However, this is an area in which the scope of administrative authority must be considered. It is not clear whether statutory change is needed at this point.

The frequency of abatement of penalties is attributed by some commentators partly to the fact that many penalties are computer generated. Many of the information reporting penalties are among those that are computer generated. Thus far, our study has not focused on the problem of computer generation. According to recent GAO testimony before the Oversight Subcommittee of the House Ways and Means Committee, the IRS does not have readily available data that would indicate the proportion of penalties and abatements that are computer generated. Accordingly, analysis of this aspect must await the development of further IRS data.

III. INCENTIVE TO CORRECT OR FILE LATE

To be fair, a penalty must be proportionate to the misconduct. Under current law, in most cases, the same penalty applies to a person who files an information return late as applies to a person who does not file at all. This is true even though the information may be useful to the IRS for several months after the filing date.

There is no incentive to file after the due date has passed if the penalty remains the same no matter how long the delinquency. Indeed, there may be a disincentive to file late. If the filer simply does not file, the IRS may never discover the omission. If the filer files late, however, the IRS is sure to discover the delinquency and is likely to apply a penalty. This result seems to be counterproductive, assuming that the information continues to be useful to the IRS for a period after the due date.

Similarly, there is no incentive to correct an incorrect return. If the filer simply does not correct the return, the IRS may never discover the error. If the filer corrects the return, however, the IRS is sure to discover the error and may apply the penalty for failure to include correct information in an information return (Section 6723).

The existing information reporting penalties (for the most part) involve this problem. They could be described as "cliff" type penalties. That is, the full amount of the penalty applies immediately on the first day the information return becomes delinquent. Accordingly, in our report, we have recommended that, where appropriate, penalties be "phased in" probably in even steps, over a period of time for which the information is useful to the IRS. This "phase-in" would be analogous to the delinquency penalties imposed upon the taxpayers by Section 6651 of the Code.

IV. MAGNETIC MEDIA

A similar problem concerns magnetic media filing. In general, magnetic media is required for payors when the number of payees for whom they must report reaches a given level. In the case of interest and dividend reports, the statute (Section 6011) provides that the level is 50 payees. In the case of most other information returns filed in 1988, regulations provide a threshold level of 250 payees. While waiver is permitted for undue hardship (related mainly to cost), there appears to be no discretion in the IRS to deal with the "notch" problem where the payor miscalculates the number of payees for a given year. The payor may have an incentive not to file a report for the 51st payee, in order to avoid a penalty. Certainly, there should be some discretion in the IRS to abate the penalty, depending upon an honest mistake by the payor in estimating the number of payees. Also, perhaps a de minimus exception would help.

V. FIRST-TIME OFFENDERS vs. REPEAT OFFENDERS

The Task Force recommends that consideration be given to a distinction between first-time and repeat offenders. Such a distinction makes sense for several reasons. First, a penalty should be proportionate to the misconduct. Repeat offenses imply greater culpability, especially if the offenders have been "caught" before. Thus, ignorance of the requirements is not a factor. Also, as the IRS Task Force has recognized, if a penalty is designed mainly to foster voluntary compliance and not just to punish or raise revenue, not every failure to satisfy requirements needs to be penalized. Where the taxpayer (or information reporter) has made a reasonable effort to comply and, yet, has failed, or where he was (reasonably) unaware of particular requirements, perhaps some leniency should apply. The function of the penalty - to promote voluntary compliance - may be better served in such instances by education and assistance in compliance. Whether such a policy can be implemented administratively by waiver or abatement of penalties under present standards of "reasonable cause" or whether a legislative change is required, perhaps providing that no penalty will be imposed in the first instance for such first-time offenders, should be considered.

VI. VARIATION IN PENALTY AMOUNT ACCORDING TO AMOUNT REPORTED

Further, in connection with the fairness concept, that is, tailoring the penalty to the conduct involved, it has been suggested that penalty rates should vary depending upon the "tax harm" arising from the failure to report. However, the term "tax harm" may itself be somewhat misleading, since the reporter has no tax involved and, indeed, normally cannot determine the amount of tax liability of the taxpayer which may result from a given item. The concept is nevertheless worth exploring.

In general, many believe that a distinction should be drawn between the failure to report a small item and the failure to report a large item. Presumably, this is based on the assumption that the tax resulting from the large item normally could exceed the tax resulting from the small item. Thus, the reporter's culpability may be viewed as greater as to the large item than as to the small. Accordingly, we have recommended in those limited circumstances where appropriate that penalties vary according to the amount involved.

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[1] See "Gross Tax Gap Estimates and Projections for 1973-1992," IRS Research Division Pub. 7285 (3-88), at pp.5-6; ABA Commission on Taxpayer Compliance Report and REcommendations (July 1987), at pp. 23-24.

[2] As the ABA Task Force report states in its general introduction concerning the purpose for and criteria for evaluating penalties, penalties (1) are appropriate elements of an overall administrative effort to achieve voluntary compliance, (2) should be perceived as fair and reasonable in relation to the misconduct, (3) should be imposed to deter specific misconduct, (4) should not be adopted retroactively, and (5) should not be imposed to punish conduct which is proper, reasonable and appropriate.

STATEMENT
OF THE
AMERICAN COUNCIL OF LIFE INSURANCE
Before the
SENATE FINANCE COMMITTEE
on
INFORMATION REPORTING/PENALTIES

September 28, 1988

Mr. Chairman and members of the Subcommittee, my name is Thomas Cotter. I am Tax Consultant at the Aetna Life Insurance Company. I am appearing today on behalf of the American Council of Life Insurance. I am accompanied today by Stephen Kraus, Senior Associate General Counsel at the ACLI. The Council has 646 member life insurance companies which account for approximately 94% of life insurance in force in the United States and over 97% of the insured pension business.

We appreciate the opportunity to present our views on information reporting which is both timely and welcomed. Our statement today will be directed primarily to information reporting requirements and the problems encountered by our member companies as information reporters.

General

During the past several years, information reporting requirements and accompanying penalties have increased significantly. The insurance industry appreciates the Internal Revenue Service's need to implement its compliance efforts, and has, and continues to, put forth very significant and costly efforts to comply with the complex and often confusing information reporting provisions of the Internal Revenue Code and related regulations. However, certain of the statutory and regulatory requirements imposed and the practices instituted need to be re-evaluated. Rulemakers need to have a greater appreciation of the impact that information reporting has upon the day-to-day operations of third party information reporters as well as a greater sensitivity to the increasing burdens of those requirements. One means of heightening this awareness would be to provide greater opportunities and forums for a continuing dialogue between third party information reporters and the rulemakers during the development and implementation of information reporting rules. A better understanding of industry operations and problems would serve to obviate some of the confusion and frustration resulting from continually changing requirements.

As the Commissioner's Task Force study has indicated, the information return reporting system relies largely on the furnishing of accurate information by third parties. If this is to be successful, information reporting requirements must be fair, sensible, and the product of a cooperative effort.

Notification Process

The notification process raises a number of concerns. The code provides that in the case of any reportable payment, if the Secretary notifies the payor (referred to as a "B" notice) that the Taxpayer Identification Number (TIN) furnished by the payee is incorrect, the payor shall withhold from such payment. In addition, the Code provides that if a payee underreports his interest or dividend income, the Secretary may notify all payors of interest and dividends to that payee of that fact and of the requirement to withhold from future payments (referred to as a "C" notice). The "B" notice sent by the Service to payors consists primarily of a computer tape prepared in IRS format listing those payees with missing or mismatched TINs. The "C" notice is on paper and is sent to payors at numerous times during the year. It may list as few as two payees or, as has happened on at least one occasion, as many as 800.

There seems to be a prevailing assumption that it is a minor task for information reporters to immediately allocate computer time and data processing resources to respond to these notices. This assumption is erroneous. Receipt of the notices, especially at year end, is extremely disruptive to the normal workflow of business operations because most companies are faced with a crush of year end reports. Information reporters must cope with the growing information demands of their businesses and a number of other federal and state regulatory agencies. To accommodate this, "B" and "C" notices should be mailed within an established timeframe (after February 28 and before September 1 of the year) with no more than one of each notice issued each year.

It should be noted that the Service has announced that, in response to GAO criticism that the Service is not cooperating sufficiently with payors, it would send "B" notices in November of each year commencing in 1988 for the 1987 reporting period. We in the industry are unable to understand how a November notice aids the payor in any way. November is the height of its year-end reporting period. With reporting forms needed to be mailed to payees by January 31, it would be impossible for any medium or large size reporter to correct its TIN records in response to a November receipt of a "B" notice in time for the current year's mailing. To the contrary, receipt of a "B" notice in November is almost sure to generate more errors.

Attached is a chart (Appendix A) depicting the year-end transaction processing requirements of one of our larger member companies that introduced a twenty-seven page presentation to year-end processing personnel. For purposes of brevity, we have included only pages 1 and 2, and pages 21 thru 27, the latter depicting the tax portion of the entire process. You will note that the presentation was made on June 1, 1988 to allow time to prepare for the 1988 year-end processing season.

Second, to assist information reporters to respond in a timely manner, procedures need to be established which would ensure that information reporting notices or requirements are received by proper persons within the reporting companies. In the framework of today's multi-structured corporations, normal day-to-day operations, such as, for example, those associated with mail distribution, can be quite complex. Information notices that are sent to the wrong office or wrong person can spend days circulating within a company before reaching the office having responsibility for information reporting. In this regard, the Service could assist reporter compliance by establishing procedures that would ensure that the "B" and "C" notices are sent to the person or office requested by the information reporter.

Third, information provided on the notification tapes needs to be enhanced to facilitate timely processing. For example, many companies utilize the "account number" fields (as specified in IRS Publication 1220) to document the source of the data within the company. Absent such information, companies have to run the notice tape against all data bases within the company just to determine where to send the tape information so that a payee notice can be generated. This process is extremely costly and needlessly time consuming since the original filing with the Service ordinarily includes the information that would have allowed the company to more rapidly process the notice tapes. It is urged that the notice tapes contain information identical to that required to be provided by the information reporter on tapes it submits to the Service; that the error type be identified for the reporter (e.g., a particular TIN not assigned); and that different types of information returns be separately identified. This latter information facilitates action by information reporters who have decentralized Form 1099 reporting with different system formats in different geographic locations.

Fourth, unreasonable reporting requirements should not be imposed upon third party information reporters. For example, regulations regarding "B" notices place enormously onerous burdens on payors. For one, payors are required to institute backup withholding on withdrawals from accounts to which previously credited reportable payments have been made. And this must be done within seven business days of receipt of the notice. (Receipt is defined as the date on the notice placed there by the Service.) Such a requirement is not provided for by statute and is unworkable. Secondly, within five business days (also an unworkable requirement), payors are required to send to the payee a multi-page statement so complicated in both appearance and content as to dwarf by comparison the complexity of the original estimated tax declaration produced by the Service in response to Tax Reform Act of 1986 requirements. While, admittedly, the statute now requires the payor to send such a notice to the payee, we urge that this requirement be reviewed and revised. It makes far more sense for the Service to send such a notice. The response thereto undoubtedly would be far greater and more prompt than if sent by the payor.

The Service has in fact undertaken at least a trial program of sending erroneous TIN notices to payees. Witness Form 8355 attached to this Statement (Appendix B). Inexplicitly, however, the form does not require the payee to provide a TIN under penalty of perjury or to certify freedom from withholding due to underreporting of dividends or interest.

Fifth, information reporters should not be saddled with the burden of resolving name mismatches which is properly the responsibility of the Internal Revenue Service or the Social Security Administration. The Service considers a TIN to be incorrect if either the name or the TIN on an information return does not match the name and associated number in the Social Security Administration's or IRS' files. The Code requires the payor to provide on a return a correct TIN. It does not impose a penalty merely because a name on an information return does not correspond with one in the Social Security Administration's records.

Backup Withholding

Another area of concern involves backup withholding. The regulations require payors who are notified of an incorrect TIN to backup withhold on all reportable payments from other accounts of the payee having that incorrect TIN. This requirement, which is extremely costly and difficult to implement should be limited in its application to take into consideration the practical problems confronting information reporters. Many life insurance companies conduct their business and maintain their accounts using many different approaches and systems depending on, for example, products or services involved, the extent of operations, and organizational structure. Smaller companies often lack sophisticated computer systems or capacity, and larger companies must cope with the problem of dealing with millions of policyholders cutting across state and national boundaries. Many companies maintain account records in many locations throughout the country depending on the type of account and payment involved. Although each location may have the ability to check all of the accounts in its system, it often does not have the ability to check accounts in different locations because, for example, different computer systems are maintained at different locations, or no systems are in place that would allow each location to check the records contained in a different location's system. Moreover, for many smaller companies, the data base is often limited, and even if operations are local, the systems therein are often incompatible. Practical limitations to information reporting cannot sensibly be ignored.

Application of penalties. A further area of concern is the application of the information reporting penalty provisions. As respects pre-1984 accounts, notwithstanding that information reporters have put forth the efforts to obtain certified TINS; have incurred the expense of separate and non-separate mailings required by the regulations for years prior to 1988, and have paid the penalty for years when they failed to make the required mailings, they are unable to satisfy the due diligence test and remain subject to the penalty until 1988 and future years. Although the Commissioner's relaxation of the strict interpretation given to the "due diligence" standard effective for years after 1988 is certainly appreciated, relief from the information reporting penalties should not be limited to 1988 and future years but should be abated from the time the mailings were made. The needless imposition of penalties under such circumstances does nothing to further the compliance effort.

According to the Service, the only way a payor may exercise due diligence for post-1983 accounts in "attempting to satisfy the requirement with respect to" supplying a correct TIN on an interest or dividend return or statement is to actually obtain a TIN certified as correct by the payee. Nothing short of actually obtaining a certified TIN is acceptable, even if withholding is immediately implemented. Except in the relatively rare "awaiting TIN" situation, no other effort will do, thus requiring the payor either to refuse to open an account or to close it if already opened (a legal impossibility in life insurance situations). This position is based neither on statutory language, legislative history, logic nor common business sense. And, while it may be defensible for a savings account (a doubtful supposition), it bears no reality to the life insurance area where, in most situations, interest is not credited to a taxpayer's "account" until two or more years after the policy is issued. Certainly, an alternative standard that would both protect the Code's information-matching objective and the payor's business objectives could be readily devised. For instance, two separate first-class mail demands within 90 days of issuance of the policy may be appropriate. It may also be appropriate to require that one of them be by certified mail, return receipt requested; an expensive and reasonably onerous burden on the payor which will be sufficient to motivate him to immediately obtain a certified TIN in most instances

Also, a number of situations exist where a payor is required to make payment, regardless of whether the payee provides a certified TIN, or any TIN at all. For example, state insurance laws generally require the prompt payment of death proceeds under life insurance and annuity policies. Interest is generally paid on such proceeds from the date of death to the date of payment. While the insurance company may request a certified TIN, it has no choice but to make the payment, subject to backup withholding, if the beneficiary refuses to provide such certification, or even refuses to provide any TIN at all.

Obviously, there needs to be alternative criteria, the meeting of which will satisfy the due diligence test. Payors who have not obtained certified TINs from payees for post-1983 accounts who have made the appropriate mailings and have instituted backup withholding should not be subject to an information reporting penalty if they fail to close the account. Moreover, given the population for which information returns are required, the opportunities for inadvertence, and the reality that no system is perfect, an acceptable error rate should be established which would preclude application of a penalty.

The due diligence regulations provide that the filing of a corrected reporting form after its due date but before the due date for filing a corrected return will not excuse the payor from penalty if the TIN on the original return was erroneous or missing. This is unfair. While we understand that the Service's production cycle may have to be based on the returns as originally filed, upon audit or appellate review, appropriate correction should lead to appropriate penalty abatement. Basic due process demands such a result.

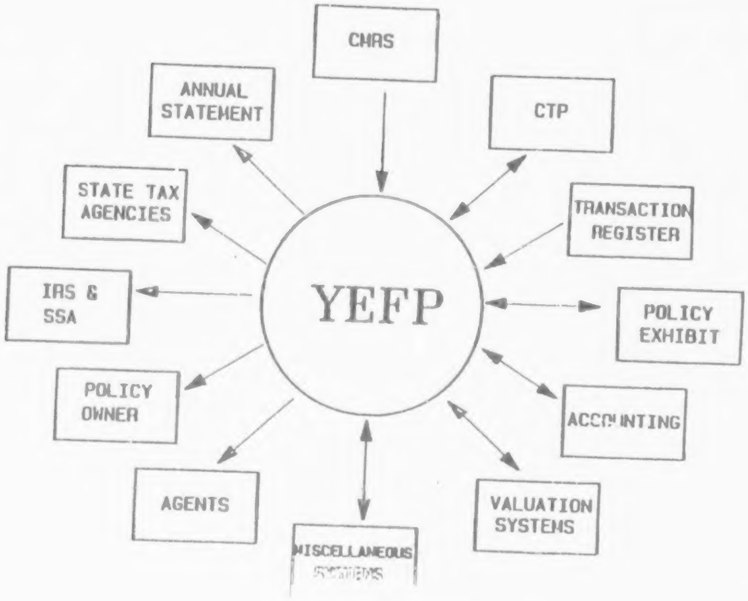
In addition, the Service needs to assume more responsibility for obtaining and determining the correctness of payee TINs. Imposing the burden solely on payors is unfair, inappropriate, and inefficient. If a payor makes a reasonable effort to obtain a certified TIN through mailings and backup withholding, it should not have to incur the continuing mailing expense year after year. If the payor has not gotten a response to its request for a TIN, the IRS should follow up with the payee. The IRS presently has statutory authority to impose a penalty on payees who fail to provide their TINs to payors. An exercise of that authority would certainly be more effective to achieving compliance than the presently unlimited annual non-separate mailing request.

The Service has been reluctant to impose payee penalties. We understand that it believes payors are in a better position to obtain TINs than the Service and, therefore, will not take steps to impose a penalty on the person truly responsible for most TIN errors and omissions -- the payee. However, the Service has received the payor's best information concerning the identify and location of the payee. Every Form 1099 filed bears the payee's name, address and TIN, if available. Thus, the Service, with its great enforcement capabilities and the persuasiveness of its very name, is put on an equal footing with the payor to obtain the TIN and extract a $50 penalty from those who refuse; a capability denied payors.

The due diligence regulations require payors to annually request a payee's TIN if the TIN in the file has not been certified as correct by the payee. There is no limit to the number of such solicitations. These mailings have proved to be minimally effective in obtaining missing or uncertified TINs. A requirement that the payor continue them in perpetuity is at least inappropriate. Such mailings should be required for no more than two or three years; especially in view of the Service's unused enforcement capabilities.

And finally, consideration also needs to be given to culling the maze of information reporting penalties that clutter the Code. Moreover, penalties should have clearly defined standards that trigger their application and should be tailored so they are appropriate to the infraction. For example, section 6652(e) of the Code provides a penalty of $25 a day for each day that a failure to file a return or statement continues with a $15,000 cap on each occurrence but with no overall cap. This clearly seems to be excessive for a reporting penalty especially when companies are often required to process thousands of information returns and opportunities for inadvertence abound.

Thank you, Mr. Chairman, for the opportunity to present our views. We look forward to working with you in the future.


CMRS
ANNUAL STATEMENT
CTP
STATE TAX AGENCIES
TRANSACTION REGISTER
IRS & SSA
YEFP
POLICY EXHIBIT
POLICY OWNER
ACCOUNTING
AGENTS
VALUATION SYSTEMS
MISCELLANEOUS SYSTEMS

APPENDIX A

YEAR END FILE PASS SYSTEM (YEFP)

DESCRIPTION:

* PERFORM AN INVENTORY OF THE CMR AND VLI FILES, COMPILING FINANCIAL AND INSURANCE DATA FOR THE ANNUAL STATEMENT, GOVERNMENTAL AGENCIES (IRS & SOCIAL SECURITY ADMINISTRATION) AND VARIOUS DEPARTMENTS THROUGHOUT THE COMPANY.

* PROCESS THE ENTIRE CMR FILE ABOUT 3.3 MILLION RECORDS PER SEGMENT. THERE ARE 5 SEGMENTS ABOUT 16.5 MILLION RECORDS. CONCERNED WITH PREMIUMS, DIVIDENDS, LOANS, TAX REPORTING, AND STATISTICS.

JUN 7,1988

OBJECTIVES:

* PROVE WHAT HAS BEEN PROCESSING IN CTP, ACCOUNTING, VALUATION, AND POLICY EXHIBIT FOR PAST YEAR IS CORRECT.

* PRODUCE WORKSHEETS WHICH ARE USED AS INPUT TO THE ANNUAL STATEMENT.

* PRODUCE AND MAIL ALL 1099INT, 1099R, AND 1099MISC TAX FORMS FOR THE COMPANY.
* PRODUCE ALL TAX REPORTING RECORDS ON A MAGNETIC MEDIUM TO BE FORWARDED TO THE IRS AND SSA.
* PRODUCE SEVERAL AGENT FILES TO BE USED FOR STUDIES AND COMPENSATE AGENTS.

TAXES:

I. REPORT INCOMES AND DEDUCTIONS

* INDIVIDUAL

* FEDERAL GOVERNMENT

* STATE GOVERNMENT

* ORIGINAL AND/OR CORRECTION

II. TYPES OF FORMS REPORTED TO THE IRS

* 1099INT INTEREST

* 1099R ORDINARY INCOME

* 1099MISC MISCELLANEOUS

* 5498 ROLLOVER AND IRA'S

* 1098 MORTGAGE INTEREST DEDUCTION

III. TYPES OF FORMS TO THE SSA

* W2 FICA, SALARY, WAGES

* W2P PENSIONS

IV. TYPES OF FORMS TO CANADA

* T5 INTEREST ($100)

* REVELE 3

V. MAILINGS AND REPORTING

A. UNITED STATES

* INDIVIDUAL BY JANUARY 31

* GOVERNMENT 2/28

* CORRECTIONS 10/31

B. CANADA

* INDIVIDUAL BY 2/28

* GOVERNMENT 3/31

VI. IRS REPORTING

* COMPANY 300 FORMS MAGNETIC MEDIA

VII. STATE REPORTING

* 25 STATES REQUIRE FOR INTEREST

VIII. COMBINED FEDERAL STATE REPORTING:

* IRS ONLY

* OKLAHOMA

* 1099INT, 1099R, 1099MISC,
5498, 1098.

INTERFEST 1099INT:

I. U.S. (1,500,000)

- * $10.00 OR MORE
- * ANY BACKUP WITHHOLDING FROM CTP
- * PPIA-NYLIC AND NYLIAC (DISCOUNT)
- * BENEFICIARIES NYLIC AND NYLIAC
- * SUPPLEMENTAL CONTRACTS
- * USE ZIP+4 AND PRESORT

II. CANADA (10,000)

- * $100.00 OR MORE

ORDINARY INCOME - GAINS, ROLLOVERS 1099R:

- * $1
- * WITHHOLDING
- * STATES (2 PART FORM)
- * NYLIC AND NYLIAC
- * GROUP PENSIONS
- * PAYROLL (EPSI)

MISCELLANEOUS INCOME 1099MISC:

I. RECIPIENT

- * DOCTORS
- * PARAMETICS
- * LABRATORIES, ETC
- * BOARD OF DIRECTORS

II. SYSTEMS

- * GROUP INDIVIDUAL NYLIC
- * GROUP NYLIC (483 COMPANIES)
- * HEALTH CARE PAYMENTS
- * MUTUAL OF OMAHA
- * PAYROLL
- * GROUP COMMISSIONS

SCREENS (VM DATA ENTRY)

PRODUCE PAPER FOR INDIVIDUAL AND ALSO FILE WITH GOVERNMENT ON MAGNETIC MEDIA

I. ORIGINALS
  * KEY IN ORIGINAL FOR MISSED RECORDS (3000)
  * NO ISSD SYSTEM
  * KEY IN JANUARY

II. CORRECTIONS
  * KEY IN 700-800 WEEK
  * KEY IN FEBRUARY TO XXXX
  * MAGNETIC MEDIUM

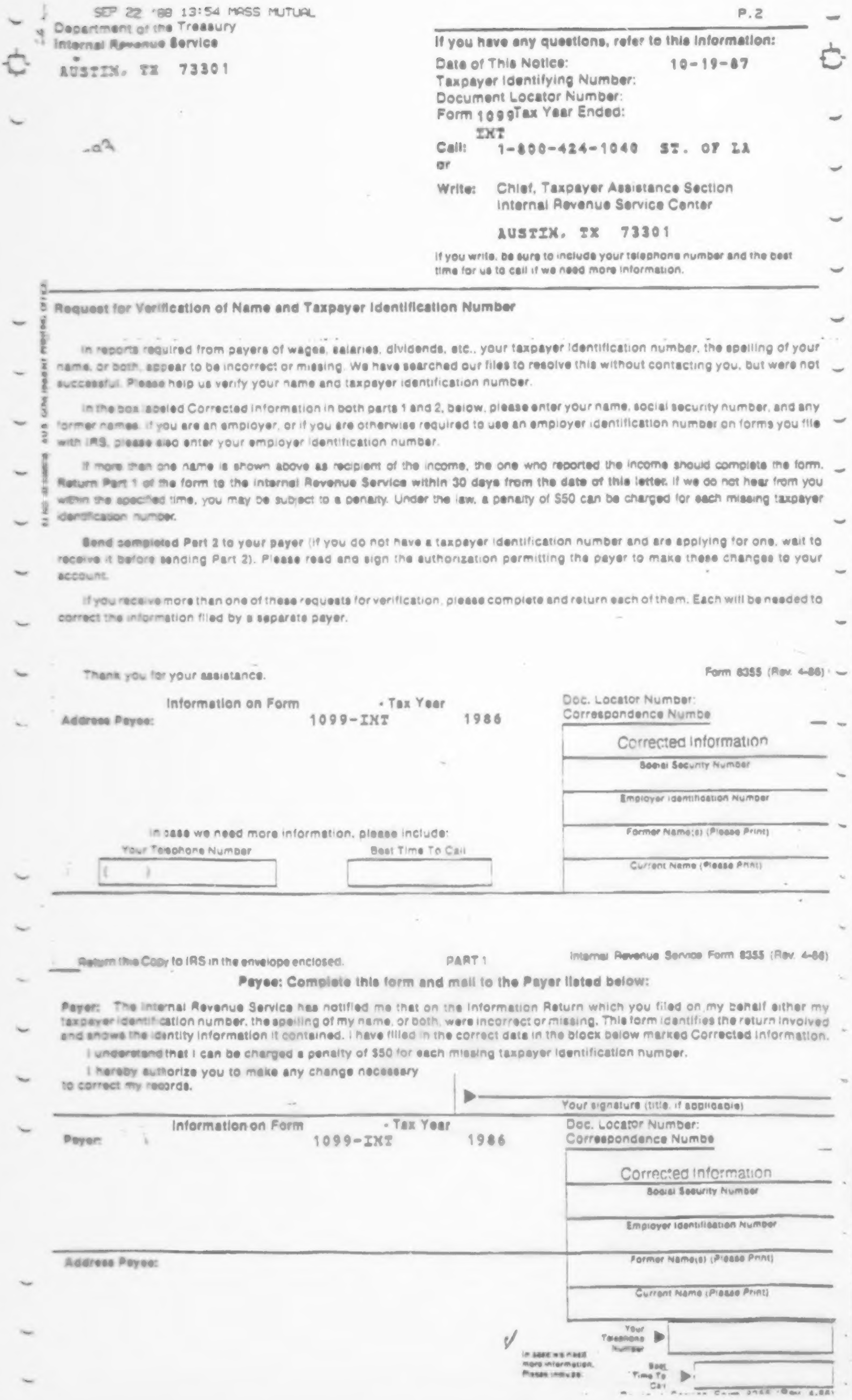
III. AVAILABILITY
  * KEY DAILY
  * PROCESS WEEKLY
  * PRODUCE REPORTS TO USERS

OTHER FORMS:

I. IRS
  * 1098 MORTGAGE INTEREST
  * 5498 IRA'S

II. SSA
  * W2
  * W2P'S
    * STANDARDIZE FOR 1988
    * SEVEN DEPARTMENTS PRODUCING
    * FOUR PART FORM

APPENDIX B



SEP 22 '88 13:54 MASS MUTUAL

P.2

Department of the Treasury
Internal Revenue Service
AUSTIN, TX 73301

If you have any questions, refer to this information:

Date of This Notice: 10-19-87
Taxpayer Identifying Number:
Document Locator Number:
Form 1099 INT Tax Year Ended:

Call: 1-800-424-1040 ST. OF LA
or
Write: Chief, Taxpayer Assistance Section
Internal Revenue Service Center
AUSTIN, TX 73301

If you write, be sure to include your telephone number and the best time for us to call if we need more information.

Request for Verification of Name and Taxpayer Identification Number

In reports required from payers of wages, salaries, dividends, etc., your taxpayer identification number, the spelling of your name, or both, appear to be incorrect or missing. We have searched our files to resolve this without contacting you, but were not successful. Please help us verify your name and taxpayer identification number.

In the box labeled Corrected Information in both parts 1 and 2, below, please enter your name, social security number, and any former names. If you are an employer, or if you are otherwise required to use an employer identification number on forms you file with IRS, please also enter your employer identification number.

If more than one name is shown above as recipient of the income, the one who reported the income should complete the form. **Return Part 1 of the form to the Internal Revenue Service within 30 days from the date of this letter.** If we do not hear from you within the specified time, you may be subject to a penalty. Under the law, a penalty of $50 can be charged for each missing taxpayer identification number.

Send completed Part 2 to your payer (if you do not have a taxpayer identification number and are applying for one, wait to receive it before sending Part 2). Please read and sign the authorization permitting the payer to make these changes to your account.

If you receive more than one of these requests for verification, please complete and return each of them. Each will be needed to correct the information filed by a separate payer.

Thank you for your assistance.

Form 8355 (Rev. 4-86)

Address Payee:

Information on Form 1099-INT
- Tax Year 1986

Doc. Locator Number:
Correspondence Numbe

Corrected Information
Social Security Number
Employer Identification Number
Former Name(s) (Please Print)
Current Name (Please Print)

In case we need more information, please include:
Your Telephone Number ( )
Best Time To Call

Return this Copy to IRS in the envelope enclosed.

PART 1

Internal Revenue Service Form 8355 (Rev. 4-86)

Payee: Complete this form and mail to the Payer listed below:

Payer: The Internal Revenue Service has notified me that on the Information Return which you filed on my behalf either my taxpayer identification number, the spelling of my name, or both, were incorrect or missing. This form identifies the return involved and shows the identity information it contained. I have filled in the correct data in the block below marked Corrected Information.

I understand that I can be charged a penalty of $50 for each missing taxpayer identification number.

I hereby authorize you to make any change necessary to correct my records.

▶ Your signature (title, if applicable)

Payer:

Information on Form 1099-INT
- Tax Year 1986

Doc. Locator Number:
Correspondence Numbe

Corrected Information
Social Security Number
Employer Identification Number
Former Name(s) (Please Print)
Current Name (Please Print)

Address Payee:

✓

In case we need more information, please include:
Your Telephone Number ▶
Best Time To Call ▶

BEST AVAILABLE COPY

STATEMENT OF KENNETH W. GIDEON
BEFORE THE
SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS
AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

September 28, 1988

Mr. Chairman, I am pleased to appear today to support a thorough review of civil tax penalties. In particular, I want to commend you for your efforts to focus attention and study on this important subject both through your public statements and your organization of a Task Force on this important subject. My practice experience includes representation of clients large and small before all levels of the Internal Revenue Service and the three courts which review its determinations as well as service as the Chief Counsel for the Internal Revenue Service approximately five years ago. That practice experience has convinced me that civil tax penalties are both an appropriate and effective compliance tool.

Recent legislative enthusiasm for penalty increases has, however, resulted in a substantial increase in the number of penalty provisions as well as broader penalty coverage and enhanced penalty severity. This enthusiasm has, I fear, been generated more by the "quick-fix" revenue estimates such increases have provided than by a careful consideration of how such increases would enhance compliance. The revenue-driven penalty system we have constructed in recent years lacks coordination, does not adequately distinguish between negligent or intentional noncompliance and good faith disputes and errors, and, perversely, may punish the latter more severely than the former. Worse still, the penalty structure is now so complex that much of its potential deterrent force is lost because taxpayers can not comprehend the minutiae of more than 150 separate penalty provisions.

This is not to say that the Congress should return to the penalty structure of 1980 or before. There are many worthwhile features of the current structure worthy of retention. However, I believe that penalties should be judged based on their potential for enhancing compliance, not raising revenue. Indeed, I believe that when penalties are forced to do double duty as compliance enhancers and revenue raisers, the revenue objective soon overwhelms the compliance objective.

As a case in point, I offer the history of the substantial understatement penalty, section 6661. Originally conceived as a low-rate (say 5%), "no fault" audit charge, its objective was to provide a "downside" cost for noncompliance whatever the reason. As enacted, it contained exceptions for "substantial authority" and "disclosure" and, largely for revenue reasons, was imposed at 10%. (Given the fact that the negligence penalty was then only 5%, this penalty, from a compliance standpoint, was either too high or the negligence penalty was too low if the severity of the penalty should vary with the severity of the noncompliant behavior.) Perhaps the ultimate irony in this penalty's career, however, was its increase to 20% then 25% at the time when Congress was exterminating the shelters which prompted its enactment by adding the passive loss rules to the Code. Worse yet, the last increase was retroactive and hence could not possibly deter conduct which had already occurred. The penalty also bears nondeductible interest from the due date of the return (not from the date of assertion). It can therefore easily increase the cost of inadvertent noncompliance or even a good faith contest by well in excess of 35% if assessed at the end of the three year limitations period.

It is doubtful that this kind of geometric increase in severity can be justified based on compliance needs - nor was there even much pretense in that direction at the time of the last increase. It was a revenue raiser in a budget reconciliation.

Accordingly, I conclude that if Congress is serious about penalty reform, the first requirement is that Congress in effect "take the pledge" not to meet revenue requirements with penalty provisions. Increasing the burdens of noncompliant taxpayers will always appear to be a politically attractive proposition in the abstract by comparison to a general tax increase or repeal of a favored deduction.

I believe, however, that this view is tenable only as an abstraction. Given the complexity and novelty of much of the Code, it is predictable that there will be much inadvertent and good faith noncompliance during the next few years. Do we really want to increase the burden of such a "miss" by 35%? Is it appropriate in the post-shelter environment we now face? Are taxpayers likely to perceive such a penalty as fair or appropriate? What will be the effect on their future behavior if they believe the penalty was excessive or unfair?

These are the appropriate questions. I suggest that when penalties are evaluated as revenue raisers, such questions are often not even asked. Therefore, I have little hope that we can truly rationalize the penalty system to serve compliance ends so long as it is revenue-driven. It is simply too easy to score a little revenue by penalizing some newly defined taxpayer sin or to increase the toll on those already branded sinners. There is, of course, a political limit to all this -- those who think otherwise have forgotten that tax revolt was a mainspring of the American Revolution. That political reaction will not be long in coming if taxpayers perceive the penalty system as a "gotcha" system of concealed tax increases levied on those unlucky enough to be selected for audit, rather than as appropriate additions for avoidable and recognizably wrong actions.

What's wrong with the current system? First, it is too complex. There are too many penalty provisions, with too many intricate special rules. Second, it is not integrated. Taxpayers are often faced with three and even four penalties assessed on the same transaction. Third, penalty severity often bears no relationship to the seriousness of the noncomplaint behavior. The revenue-focus of recent enactments has led to increases in widely applicable penalties while less frequently imposed penalties such as negligence have largely been ignored. This has produced the anomaly that our sanction for the mildest form of noncompliance -- substantial understatement -- is now 500% of the penalty level for negligent or intentional noncompliance. Fourth, in my judgment, penalty levels are generally too high for less serious noncompliance. The increase in penalty amounts coupled with the fact that deficiency interest is no longer deductible has now dramatically increased the costs of being wrong for the slightly more than 1% who are audited -- and the most dramatic increases have been levied on the least severe forms of noncompliance. Finally, if our goal is compliance, not revenue, the Internal Revenue Service has insufficient authority to abate penalties in return for compliance.[1]

Development of a sensible penalty system requires development of an underlying consensus on why we have penalties. There are at least four basic justifications for imposition of penalties. These are:

1. Punishment - Under this approach, the penalty is a direct sanction for wrongdoing. It stigmatizes behavior as improper. It extracts a cost from the violator for the misdeed.
2. Deterrence/compliance - Under this approach, the objective is to prevent future noncompliance by the violator -- and, perhaps is even more importantly, to dissuade others from becoming violators. Stated positively, we wish to encourage compliant behavior.
3. Cost recovery - Under this approach, the Government seeks to recover its increased costs arising from

noncompliant behavior from the person causing the cost to be incurred.[2/]

4. Revenue-raising - Penalties can be imposed to raise money.

It may well be that the justification varies with the particular conduct at issue. Some charges, which I suggest should not be labeled "penalties" may be appropriately imposed as cost recovery measures on those taxpayers whose conduct requires the Government to incur an additional cost. Collection charges or fees for missing an interest payment on Schedule B might appropriately fall in this category. However, true penalties should be aimed at enhancing compliance. Insistence that penalties raise revenue (*i.e.*, that they be regularly imposed and collected) may often be incompatible with effective use of such penalties to enhance compliance. Indeed, to the extent a penalty provision is effective as a compliance tool, receipts from the provision should fall.

What are the characteristics of a good penalty system?

First, it should be compatible with existing conditions. A system of voluntary compliance is dependent on taxpayer goodwill. Taxpayers in my judgment do not perceive deficiency interest charges as unfair because they understand that they are reasonable charges for the use of money. Similarly, I think a low rate audit charge might receive similar acceptance. I question, however, whether a high rate penalty (as opposed to a low rate, no fault audit charge) will be perceived as fair if applied to good faith or genuinely inadvertent noncompliance. In an environment where the basic rules have changed as fundamentally as they have in the 1984 and 1986 Acts, I believe high rate penalties for such minimal noncompliance are particularly inappropriate.

Second, penalties should be targeted to noncompliance and should vary in severity with the severity of the noncompliant conduct. There should be a clear progession in severity, for example, in the application of penalties to simple errors, negligence (in the sense of an absence of due diligence to comply), intentional disregard of rules, and fraud (which I view as concealment or deception). In this connection, investigation of the integration of criminal law sanctions through the notion of "lesser included offenses" bears consideration here both as a way of assuring that the penalty sanction is proportionate to the severity of the noncompliant behavior and as possible answer to the problems of pyramiding penalties inherent in the current system. Similarly, criminal law concepts under which the severity of the sanction varies in proportion to the magnitude of the harm and whether the behavior is repetitive deserve consideration in your review.

Third, penalties should not be imposed on good faith disputes. In this connection, the disclosure provisions of section 6661 deserve particular attention and possible expansion. It is difficult to perceive why a taxpayer willing to identify his disagreement to the Internal Revenue Service should be subjected to a severe sanction.[3/]

Fourth, many provisions now labeled penalties would probably provoke less controversy if they were "de-stigmatized," (*i.e.*, labeled "user fees" or "late charges") and imposed in a manner which bears some relationship to the Government's costs. For example, the so-called 100% penalty imposed business officials who fail to withhold has now evolved into a back-up collection device. Its administration and the courts handling of it would be improved if it were more appropriately labeled and appropriate subrogation were provided.

Finally, penalties should enhance the general perception of the fairness of tax administration. This goal is advanced when recognizably bad conduct such as fraud or negligence bears a surcharge. High rate penalties on good faith or inadvertent noncompliance, however, have precisely the opposite effect.

Admittedly, the most difficult task you face is to draw appropriate distinctions between good faith mistakes and aggressive noncompliance. However, important and useful work has been done to assist you in this process, notably by a Task Force of the American Bar Association's Section of Taxation. Worthwhile ideas are emerging from the Internal Revenue Service's study of these problems, and other groups have indicated that they will contribute to the process. I believe that those efforts will furnish the Congress with the concepts and ideas to achieve practical and workable solutions so long as compliance (rather than revenue) is the goal.

1/ As an example of this last point, consider the information return penalties - typically $50 for failure to issue a required Form 1099. If compliance is the objective, the goal is to get the form filed, not to collect $50. An abatement provision which would reduce the penalty significantly upon prompt compliance after notice would promote form filing.

2/ While many of our current penalties have this as a justification, there has been no systematic effort to relate charges and costs. In addition, in many instances such as late payment, the charge might actually be better received by taxpayers if it were not labeled a penalty at all but a late payment charge and imposed at rates conforming to commercial practices.

3/ Disclosure is not a complete answer because a taxpayer may believe his position is so clearly right that disclosure is not required.

STATEMENT OF SENATOR JOHN HEINZ

OUR TAX LAWS HAVE ALWAYS BEEN BASED UPON VOLUNTARY COMPLIANCE. TO ENCOURAGE VOLUNTARY COMPLIANCE, LAWMAKERS HAVE ALWAYS INCLUDED A FEW PENALTIES FOR THE TAXPAYER, WHO DIDN'T WANT TO VOLUNTARILY COMPLY. THE NEGLIGENCE AND FRAUD PENALTIES WERE ORIGINALLY ENACTED AS PART OF THE REVENUE ACT OF 1918. THESE PENALTIES ARE STILL WITH US TODAY, HOWEVER, WE NOW HAVE OVER 150 DIFFERENT PENALTIES.

AS THE INCOME TAX LAWS HAVE INCREASED IN SCOPE AND COMPLEXITY OVER THE PAST 75 YEARS, SO TOO HAVE THE NUMBER AND COMPLEXITY OF THE PENALTIES GROWN. IN 1975 THERE WERE 64 PENALTIES, AND IN LESS THAN 13 YEARS THAT NUMBER HAS MORE THAN DOUBLED TO 150.

MANY OF THESE PENALTIES WERE INCLUDED TO DISCOURAGE CERTAIN BEHAVIOR, SUCH AS THE TAX SHELTER PENALTIES, HOWEVER, SOME WERE ADDED AS A MEANS OF RAISING REVENUE, RATHER THAN TO ENCOURAGE VOLUNTARY COMPLIANCE. WE MUST ASK OURSELVES WHETHER THESE PENALTIES ARE PROMOTING OR LEADING TO A DECLINE IN THE LEVEL OF VOLUNTARY COMPLIANCE?

FOR EXAMPLE, THE RECENTLY PASSED HOUSE TECHNICAL CORRECTIONS BILL CONTAINS A PROVISION WHICH WILL INCREASE THE BAD CHECK PENALTY. IF ENACTED IT WOULD INCREASE THE "BAD CHECK" FEE FROM $5 TO THE GREATER OF $15 OR 5% OF THE AMOUNT OWED. I HAVE NO PROBLEM WITH INCREASING THE FEE FROM $5 TO $15, SINCE THE PENALTY SHOULD COVER THE ADMINISTRATIVE COST. GARFINKELS OR SAFEWAY WOULD CHARGE YOU THE SAME AMOUNT. HOWEVER, INCREASING THE FEE TO 5% OF THE AMOUNT OWED, IS ACTUALLY INCREASING THE "FAILURE TO PAY YOUR TAX" PENALTY. CLEARLY THIS MEASURE WAS ADDED AS A REVENUE RAISER, AND SHOULD NOT BE ACCEPTED AT CONFERENCE.

I MUST CONGRATULATE SENATOR PRYOR ON HIS LEADERSHIP IN THE AREA OF PENALTY REFORM, AND LOOK FORWARD TO WORKING WITH HIM.

CHARLES J. MULLER, CHAIR
PENALTIES TASK FORCE
SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

Mr. Chairman and Members of the Committee:

INTRODUCTION

I am Charles J. Muller, San Antonio, Texas, Chair of the Penalties Task Force. I will outline the Task Force recommendations concerning the taxpayer penalties.

THE TAXPAYER PENALTIES

There are five separate penalties which make up those that the Task Force refers to as the "taxpayer penalties." These penalties are assessed against the taxpayer for understatement of his tax liability and for delinquency in filing his return or paying his taxes. Three of these provisions apply to general categories of misconduct and have existed in the Internal Revenue Code since the early days of the tax law. They are the fraud penalty, the negligence penalty and the delinquency penalty.

The fraud penalty applies where a taxpayer "attempts to evade" tax. The negligence penalty applies where a taxpayer intentionally disregards rules and regulations or carelessly fails to report his correct taxes. The delinquency penalty applies where a taxpayer fails to timely file a return or pay his taxes.

Two more specific penalty provisions were added in recent years. In 1981 and in 1982, respectively, Congress added the overvaluation penalty, Section 6659, and the substantial understatement penalty, Section 6661. These two penalties differ from the three general penalties, because these two penalties apply only in specific situations. The overvaluation penalty applies where a taxpayer understates his tax liabilities by relying on overstated valuations of property, commonly occurring in tax shelters. The substantial understatement penalty is a "modified no fault" penalty, which applies automatically where an income tax understatement exceeds certain mathematical limits. The penalty, however, may be avoided if the taxpayer has "substantial authority" for the position taken on his tax return or if he discloses the relevant facts in a statement attached to his tax return. Although the overvaluation penalty and the substantial understatement penalty are coordinated with each other, so that they will not both apply, they are not coordinated with the three general penalties and consequently significant overlapping and pyramiding of the penalties can result. For example, conduct which could be described under the general heading "intentional disregard of rules and regulations," could be simultaneously subject to the negligence penalty and either the overvaluation penalty or the substantial underpayment penalty. Similarly, conduct that is fraudulent can be subject to both the fraud penalty and the substantial understatement penalty, with the total penalty equal to 100% of the understated taxes.

The current negligence penalty is not "item specific"; that is, it is not based only on the portion of the underpayment attributable to negligence, but is based on the entire deficiency. As a result, the negligence penalty will vary from taxpayer to taxpayer for the identical negligent conduct and, in certain circumstances, could even exceed the penalty that would be imposed if the same item were fraudulent.

THE DELINQUENCY PENALTY

The delinquency penalty, Section 6651, applies where a taxpayer fails to timely file a tax return or pay the required tax. The penalty phases-in, so that the rate of the penalty will depend upon the length of the delinquency. For example, if a taxpayer files his return and pays the tax within one month of the due date, the penalty would be 5 percent of the delinquent taxes. If the delinquency continues for a sufficiently long period, a maximum rate of 50 percent applies. The delinquency penalty is not sufficiently coordinated with the negligence and substantial understatement penalties so that in certain circumstances the delinquency and negligence or substantial understatement penalties can be applied simultaneously to the failure to timely file a tax return.

INTEREST AND INTEREST COMPONENTS

The basic interest rate on tax deficiencies was unchanged, at 6 percent, from 1921 to 1975. In 1975 and again in 1981, Congress increased the interest rate. Also in 1981, Congress began incorporating additional interest components in the penalties themselves. At present, the Code has a regular interest provision, an interest component of the fraud penalty, an interest component of the negligence penalty, enhanced interest on certain tax motivated transactions, and two different rules for imposing interest on penalties. These multiple interest provisions are unduly complex. When considered with the pyramiding penalties, the total penalty and interest assessments can far exceed the actual tax deficiency.

SUMMARY OF RECOMMENDATIONS

The Task Force has concluded that the general taxpayer penalty provisions should be retained, but modified. A two-tiered negligence penalty would replace the existing negligence penalty. The new negligence penalty would be "item specific"; that is, it would apply only to the specific portion of an understatement attributable to negligence. The higher rate would apply to intentional conduct and the lower rate to conduct which was merely careless.

The overvaluation penalty, Section 6659, would be eliminated as redundant and unnecessarily complex.

There is disagreement over the substantial understatement penalty. The predominant view was that the substantial understatement penalty, like the overvaluation penalty, should be eliminated. In short, it was felt that a broad-based negligence penalty would apply to the same conduct and would be sufficient to deter the misbehavior without necessity of multiple overlapping penalty provisions.

The minority view favored retention of the substantial understatement penalty, but with amendments to broaden its application to other taxes besides the income tax, clarify its scope and application, and coordinate it with the negligence and fraud penalties so as to eliminate pyramiding.

The Task Force felt that certain express or implied presumptions in the penalty system are undesirable for various reasons. For example, it is believed that a "no fault" penalty should not be imposed merely because the tax deficiency exceeds certain mathematical limits. A deficiency may arise as the result of mistake or accident involving no misconduct by a taxpayer.

In addition, where any portion of an understatement is shown to be attributable to fraud, it is presumed that all the understatement is also attributable to fraud, unless the taxpayer shows to the contrary. We believe this presumption is inappropriate and unfair. We also oppose the presumption of negligence where the taxpayer fails to report an item such as interest on dividends reflected on an informational return (i.e. a Form 1099).

We have made recommendations which would coordinate the delinquency penalties with the fraud, negligence and (if retained) substantial underpayment penalties. We have recommended the elimination of the interest components of the fraud and negligence penalties, and the interest enhancement provision which applies to deficiencies arising from tax motivated transactions. It is believed that a proper [illegible] for a penalty, coupled with [illegible] adequate to deter [illegible] a matter of perceived [illegible] substantial [illegible] paid to the [illegible]

[illegible] components [illegible]

BASIC UNDERSTATEMENT PENALTY COMPONENTS

CODE SECTION	TITLE	DESCRIPTION	PROPOSED CHANGES
§ 6653(b)(1)	Fraud	75% of the portion of the understatement attributable to fraud.	Presumption of fraud repealed.
§ 6653(a)(1)	Negligence	5% of the entire understatement for a timely filed return or 5% of the total corrected tax on a late filed/or unfiled tax return.	Two tier penalty: (1) 50% of the portion of the understatement attributable to reckless or intentional conduct, and (2) 25% of the portion of the understatement attributable to simple negligence or carelessness.
§ 6661	Substantial	25% of the understatement attributable to a "substantial understatement."	Repealed or substantially revised.
§ 6659	Overvaluation	Where overstatement of basis or value of an asset results in an understatement of tax of at least $1,000: Overvaluation — Penalty 150-200% — 10% Over 200-250% — 20% Over 250% — 30% Contribution 150% and over — 30%	Repealed.
§ 6651(a)(1)	Failure to File	5% per month, maximum 25%, computed on balance due.	Coordinated with the negligence (and substantial understatement) penalty to eliminate overlapping. Where taxpayer's sole misconduct is the failure to timely file there would be a delinquency penalty but no negligence (or substantial understatement) penalty. The negligence (substantial understatement) penalty would apply to the actual understatement of tax on the delinquently filed return.
§ 6651(a)(2)	Failure to Pay	0.5% per month, maximum 25%.	No change.

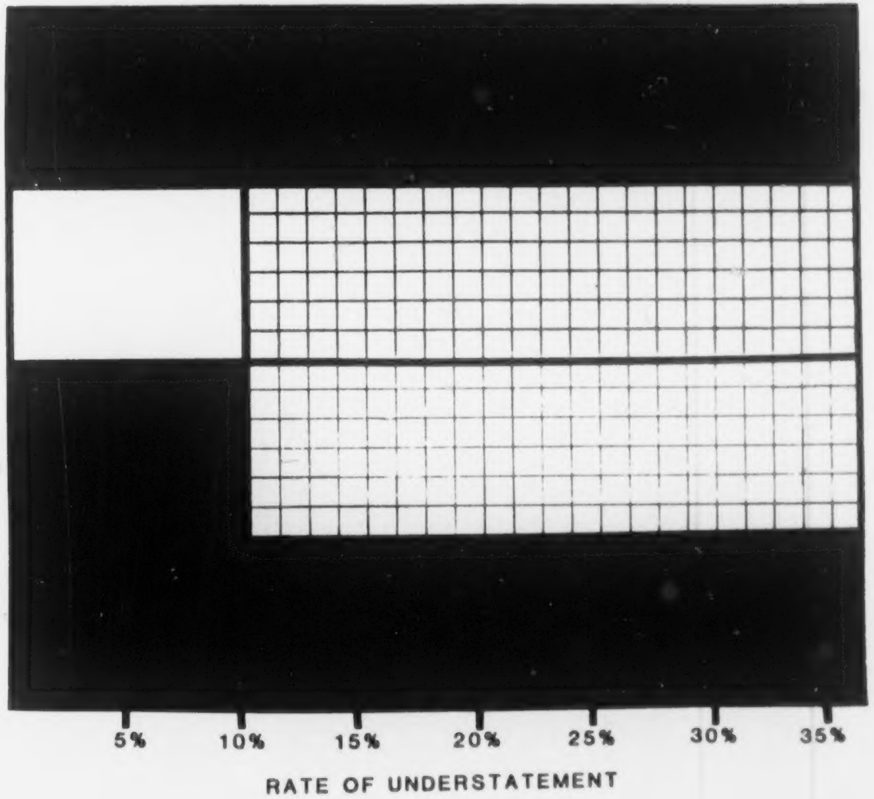
INTEREST COMPONENTS OF THE UNDERSTATEMENT PENALTIES

CODE SECTION	TITLE	DESCRIPTION	PROPOSED CHANGES
§§ 6601(a), 6621 and 6622	Regular Interest	Short-term Federal rate plus 3 percent, compounded daily, non-deductible.	No change.
§ 6653(b)(2)	Fraud Component Based on Interest	Additional amount equal to 50% of the interest on the fraudulent portion of the understatement.	Repealed.
§ 6653(a)(2)	Negligence Component Based on Interest	Additional amount equal to 50% of the interest on the negligent portion of the understatement.	Repealed.
§ 6601 (a)(2)(A)	Interest on Penalties in General	Interest on penalties (other than IRC 6651(a)(1), 6659, 6660, and 6661 penalties) will be imposed from the date of notice and demand if not paid within 10 days of notice and demand.	No change.
6601(a)(2)(B)	Interest on Certain Penalties	Interest on IRC 6651(a)(1), 6659, 6660, and 6661 penalties will begin on the date the return is required to be filed (including extensions).	Interest on all taxpayer penalties, including fraud and negligence, runs for 10 days after notice and demand.
§ 6621(c)	Enhanced Interest on Tax Motivated Transactions	The regular interest rate is increased to 120% where underpayment exceed $1,000 as the result of certain tax motivated transactions.	Repealed.

TAXPAYER PENALTIES

CONDUCT/RATE OF UNDERSTATEMENT RELATION

PENALTY	CONDUCT
fraud sec. 6653(b)	intent to evade
negligence sec. 6653(a)	no reasonable basis
substantial understatement penalty sec. 6661	less than substantial authority/not adequately disclosed
	non-negligent behavior



THE SUBSTANTIAL UNDERSTATEMENT PENALTY
SUMMARY OF THE CONTROVERSY

ATTRIBUTE	ISSUE	CONTROVERSY	TASK FORCE APPROACH
PENALTY RATE	IS A 25% RATE APPROPRIATE FOR A MODIFIED NO FAULT PENALTY?	THERE IS GENERAL AGREEMENT THAT A 5% NEGLIGENCE PENALTY IS NOT SUFFICIENT TO DETER CERTAIN INAPPROPRIATELY AGGRESSIVE TAX REPORTING POSITIONS. THERE IS CONSIDERABLE DISAGREEMENT REGARDING A HIGH RATE (25%) "MODIFIED NO FAULT" PENALTY.	BROAD BASED NEGLIGENCE PENALTY WITH INCREASED TWO TIERED RATE STRUCTURE. ELIMINATION OF THE SUBSTANTIAL UNDERSTATEMENT PENALTY.
ASSESSMENT	SHOULD A TAX PENALTY BE IMPOSED BASED UPON MATHEMATICAL RATIOS WITHOUT PRELIMINARY ADMINISTRATIVE DETERMINATION OF FAULT?	THE MAJORITY BELIEVE THAT HIGH RATE PENALTIES SHOULD BE FAULT BASED, BUT A SUBSTANTIAL MINORITY ASSERT THAT TAXPAYERS WHO "SUBSTANTIALLY" UNDERREPORT SHOULD PAY A PENALTY. REGULATIONS (BUT NOT STATUTE) PROVIDE FOR ADMINISTRATIVE WAIVER OF THE SUBSTANTIAL UNDERSTATEMENT PENALTY WHERE TAXPAYER HAS ACTED IN GOOD FAITH.	A PRELIMINARY FAULT DETERMINATION SHOULD BE MADE WHERE HIGH RATE PENALTIES ARE APPLIED. THE "REASONABLE BASIS" STANDARD REFLECTED IN THE NEGLIGENCE PENALTY IS THE PROPER STANDARD FOR BOTH IMPOSITION AND ABATEMENT OF THE PENALTY.
AVOIDANCE CRITERIA	ARE "ADEQUATE DISCLOSURE" AND "SUBSTANTIAL AUTHORITY" PROPER AVOIDANCE CRITERIA?	THERE IS SUBSTANTIAL AGREEMENT THAT A DISCLOSURE INCENTIVE IS IN THE INTEREST OF SOUND ADMINISTRATION OF THE TAX LAW. THERE IS SUBSTANTIAL DISAGREEMENT ABOUT THE DEFINITION AND APPLICATION OF THE "SUBSTANTIAL AUTHORITY" STANDARD FOR PENALTY AVOIDANCE.	THE DISCLOSURE CONCEPT WOULD BE RETAINED UNDER THE NEGLIGENCE PENALTY. "SUBSTANTIAL AUTHORITY" WOULD BE ELIMINATED BECAUSE "REASONABLE BASIS" AS REFLECTED IN THE NEGLIGENCE PENALTY IS THE PROPER TAX REPORTING STANDARD.
STANDARD OF PRACTICE	SHOULD "SUBSTANTIAL AUTHORITY" BE A STANDARD OF CONDUCT FOR TAX RETURN PREPARERS?	SINCE A SUBSTANTIAL UNDERSTATEMENT RESULTS IN A PENALTY TO THE TAXPAYER, THE TAX RETURN PREPARER'S CONDUCT SHOULD BE REVIEWED BY THE DIRECTOR OF PRACTICE. TAX PREPARERS SHOULD BE REQUIRED TO ADHERE TO A STANDARD OF CONDUCT HIGHER THAN "REASONABLE BASIS."	"REASONABLE BASIS" IF PROPERLY APPLIED IS AN APPROPRIATE STANDARD OF CONDUCT FOR BOTH TAXPAYERS AND PRACTITIONERS. NO FAULT PENALTY ASSESSMENTS SHOULD NOT BE THE BASIS FOR A REFERRAL TO THE DIRECTOR OF PRACTICE.

EXAMPLE 1

Taxpayer files his 1987 income tax return timely, reflecting a total tax liability of $30,000. The $30,000 was timely paid by quarterly estimated tax payments. On audit, IRS assesses additional taxes of $1,000 because it is determined that the taxpayer has carelessly failed to maintain certain records to support expense deductions.

PRESENT LAW

Penalty Computation:

Negligence:	5% x $1,000 = $50 + interest*

PROPOSED CHANGE

Penalty Computation:

Negligence:	25% x $1,000 = $250

*"Interest" as used in these examples refers to the interest component of the penalty.

EXAMPLE 2

Same facts as Example 1, except that IRS asserts additional tax for another item which is determined to be "no fault." The tax liability for this item is $30,000.

PRESENT LAW

Penalty Computation:

Negligence:	5% x $31,000 =	$1,550 + interest
Substantial Understatement:	25% x $31,000 =	7,750
		$9,300 + interest

PROPOSED CHANGE

Penalty Computation:

Negligence: 25% x $ 1,000 = $250

EXAMPLE 3

Same facts as Example 2, except that taxpayer asserts and proves that the $1,000 adjustment for undocumented business expenses, was in fact attributable to fraud:

PRESENT LAW

Penalty Computation:

Fraud: 75% x $ 1,000 = $ 750 + interest

Substantial Understatement: 25% x $31,000 = 7,750

$8,500 + interest

PROPOSED CHANGE

Penalty Computation:

Fraud: 75% x $1,000 = $ 750

EXAMPLE 4

Same facts as Example 2, except taxpayer files his tax return one month late.

PRESENT LAW

Penalty Computation:

Delinquency: 5% x $31,000 = $ 1,550

Negligence: 5% x $61,000 = 3,050 + interest

Substantial Understatement: 25% x $61,000 = 15,250

$19,850 + interest

PROPOSED CHANGE

Penalty Computation:

Delinquency: 5% x $31,000 = $1,550

Negligence: 25% x $1,000 = 250

$1,800

EXAMPLE 5

Same facts as Example 2, except taxpayer files his tax return one year late after several contacts by IRS.

PRESENT LAW

Penalty Computation:

Delinquency: 25% x $31,000 = $ 7,750

Negligence: 5% x $61,000 = 3,050 + interest

Substantial Understatement: 25% x $61,000 = 15,250

$26,050

PROPOSED CHANGE

Penalty Computation:

Delinquency: 25% x $31,000 = $ 7,750

Negligence: 25% x $ 1,000 = 250

$ 8,000

Statement of James E. Merritt, Morrision & Foerster
San Francisco, California

American Bar Association, Section on Taxation
Civil Penalties Task Force

Thank you, Mr. Chairman and Subcommittee Members, I am a subcommittee chair on this American Bar Association ("ABA") Task Force. I was chairman of the ABA Tax Section's Committee on Administrative Practice in 1980 through 1982 when many of these penalties were drafted and enacted.

I have two major points I would like to address: to discuss the Task Force report with regard to third-party penalties; and to present the minority view with regard to taxpayer penalties, principally the substantial understatement penalty of Section 6661.

The third-party penalties, appear to be working relatively well. There is, however, a short period of experience with regard to a many of those penalties enacted in the mid-1980's. These penalties were enacted and intended to address two different types of activities. One, conduct which would damage the tax system such as abusive tax shelters and tax protesters; and, two, conduct by generally compliant third parties, the industry that specializes in advising taxpayers and tax return preparers. The experience with tax return preparers dates back to 1976.

The good news is that tax shelters and the tax protester movement seems to be on the decline. Such decline, however, cannot be attributed entirely to the penalty system. In addition, Congress has enacted changes in the substantive tax law and the Service has increased enforcement efforts. Moreover, the courts have been supportive of enforcement. All three of these efforts, have succeeded in reducing tax shelter activity and the tax protester movement.

The third party penalties which we considered are: (1) the tax return preparer penalties, Sections 6694, 6695 and 6696; (2) the abusive tax shelter promoter penalty, Section 6700; (3) the aiding and abetting penalty, Section 6701; (4) the frivolous income tax return penalty, Section 6702; and (5) the frivolous Tax Court proceedings penalty, Section 6673. Most of my comments will address the tax return preparer penalties, but first let me describe certain specific problems and recommendations regarding the other third party penalties.

Section 6700 imposes a penalty upon promoters of abusive tax shelters. There is presently uncertainty as to whether the $1,000 penalty applies to each sale or to all sales within a year. The courts are split on this issue. Congress should make it clear that the penalty is $1,000 per sale. Congress should also provide a statutory period of limitations for this penalty. We recommend a five-year period.

The other third party penalties (Sections 6701, 6702 and 6673) primarily affect tax protesters and the Service and the courts have rigorously applied these penalties. We recommend that guidance be provided under Section 6701 particularly as it may apply to compliant groups of tax advisors in addition to tax protesters. We also recommend that the frivolous Tax Court proceedings penalty be expanded to apply in other jurisdictions.

The tax return preparer penalties which were enacted in 1976, illustrate a point I would like to emphasize: In enacting penalties and in administering penalties, both Congress and the Service should be aware of the willingness of tax advisors, other third parties as well as taxpayers to comply. The preparer penalties illustrate this very well because when they were enacted in 1976 and for the following four years, there was no guidance provided by the Service as to how preparers should adopt procedures to eliminate negligence in their preparation of tax returns. (That is the major penalty that has been applied to preparers.) There was a lot of controversy in those years. The numbers of penalties assessed was over 30,000 per year.

In 1980, as a result of discussions with the tax return preparer industry, the Service published a series of Revenue Rulings and a Revenue Procedure which set forth very adequate guidelines. As a result there is a high level of compliance by the industry. Indeed, there is no reason why any tax return preparer should be subject to the negligence penalty because they can follow the IRS guidelines and adopt what is called "normal office procedures."

In dealing with compliant groups of persons, such as those in the tax return preparer industry (and most likely the vast majority of persons who provide information returns) training, guidance and assistance in complying with the laws can be as or more successful than automatic assertion of penalties. We think the Service should provide more guidance. Of course this won't be sufficient for everyone. For example, I doubt that tax shelter promoters would have complied with more guidance. However, for the vast majority of small business taxpayers, for example, additional assistance and guidance may be the answer.

The other major point with regard to tax return preparer penalties and it relates also to the tax shelter penalties is that one must take into account the degree of severity of the penalty. Our report is based upon existing law. The existing rates for some penalties may be too low. For example, the fraud penalty--this is when a preparer has willfully violated the rules in advising a taxpayer--is $500. The negligence penalty is $100. Those seem to be very low. Indeed, if these were the only penalties involved, few people would be encouraged to comply by the penalties.

At the present those penalties are being enforced because they generate a referral to the Director of Practice who may institute proceedings to suspend or disbar a tax return preparer. Your Subcommittee may want to examine whether the amounts are adequate and whether you should consider a review of the disciplinary proceedings conducted by the Director of Practice.

I would now like to present the minority view in the Task Force report regarding the substantial understatement penalty of Section 6661. There is general agreement with regard to the need to make modifications in the substantial understatement penalty if it is retained. The minority view is simple: the substantial understatement penalty should be retained and the negligence penalty should not be modified. If the negligence penalty becomes a specific item type of penalty, it will introduce an additional level of complexity into administering the laws. The courts, taxpayers and tax lawyers are familiar with the relatively undefined concept of negligence. Wiser or greater exercize of prosecutorial discretion may be the way to solve problems regarding application of the negligence penalty as opposed to adding a great deal of complexity.

Similarly, I think the substantial understatement penalty is understood by taxpayers and persons in the tax profession. The concept of "substantial authority" is not difficult to understand. It is true it is no more defined than negligence, but negligence is understood. That is one basic concern with the majority report.

Let me just give an example or two, that I think will illustrate the problems which Section 6661 addresses. Prior to enactment of Section 6661, I am familiar with a situaiton where a taxpayer asked to take a $50 million deduction. The question was not whether or not the deduction was correct, rather it was whether it would be negligent to claim the deduction. If it were not negligent, the taxpayer could earn several millions of dollars, even though the IRS would audit and identify the issue and the taxpayer would concede the issue.

Congress has done two things since that time that have changed the rules. One is, a commercial interest rate is now levied on underpayments and that was very important to do. Second, there is a downside risk: that is the substantial understatment penalty. At the time it was enacted it was 10 percent, which we believe is a more proper level for it than the current 25 percent. As a result of these changes, a taxpayer no longer profits from a reasonable basis position which will not prevail.

There is also a marketplace for tax saving ideas that Congress and the Service must try to control. Clients I work with are frequently approached by various people with one proposal or another that will save them millions of dollars. After the enactment of Section 6661, these people must represent whether or not there is "substantial authority" for their position. Taxpayers are unlikely to engage in such transactions unless they are supported by "substantial authority." Enactment of the substantial understatment penalty and the substantial authority concept has raised the level of the playing field. If you eliminate it, you will reduce the level of practice back to where the question will be does this avoid the negligence penalty. The minority view is that the substantial authority standard is healthy. It requires that the taxpayer and his advisor have a fairly high degree of authority for a position.

Although we support the substantial understatement penalty, it should be modified. The greatest problem is that the regulations contain an unrealistic and unduly restrictive definition of "authorities." Every day, in my practice--and I know it is true of persons in government practice as well--when we try to interpret the tax laws, we research not just the statute, regulations and court cases, we also research proposed regulations, written determinations issued by the IRS and the "Blue Book" published by the Joint Committee. We consider all of those authorities to interpret the tax laws. Many times there are no regulations nor court cases on point and the major available authorities are the legislative history of the statute regarding the intent of Congress and written determinations which reveal the Service's interpretation.

None of these research resources are considered to be "authorities" by the IRS: not proposed regulations, not written determinations which they have issued, not the "Blue Book." That is just plain unfair. It is unfair and improper to penalize a taxpayer for interpreting the tax law the same way the IRS has in a proposed regulation. The definition of authorities should be expanded to make the substantial understatement penalty fair and more comprehensible.

The substantial understatement penalty should be coordinated with other penalties, so that other penalties are not imposed for the same conduct. There is an egregious situation developing with regard to the lack of coordination between the substantial understatement penalty and the delinquency penalty. If a taxpayer files a correct return, but files it late, it should be subject to the delinquency penalty only. That is the only thing the taxpayer has done wrong. If a taxpayer files a late return and there is also a substantial understatement on that return, he should be subject to both penalties. The problem is that there are interpretations by the IRS that a late return is *per se* a substantial understatement. I do not see any justification for that in the statute or in logic.

Those are the major points of disagreements and the major points of clarification that I believe should be made in the substantial understatement penalty.

I appreciate the opportunity to appear before you today and I will be happy to answer any questions.

STATEMENT OF SENATOR DAVID PRYOR
CHAIRMAN OF THE FINANCE SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

This is the second of three hearings before this subcommittee to review the penalties of the Internal Revenue Code. In 1975, the Administrative Conference of the United States called the 64 penalties of the Code "mind-numbing." Thirteen years later that mind-numbing array of civil penalties has grown to over 150, and is a morass of inconsistency and irrationality that often discourages, rather than encourages, compliance.

These hearings have been called to receive comment from the public on what Congress can now do to clean up this mess. From the testimony of the first hearing, a number of key issues seem to be rising to the top.

The overwhelming response has been a concern that small businessmen and women often bear the brunt of the present system. This subcommittee will be particularly concerned in finding ways to relieve this burden. I look forward to receiving testimony on this subject today.

Additionally, the present system suffers from numerous structural inadequacies. It punishes the barely compliant as severely as the professional tax cheat. Taxpayers often find themselves with huge obligations as a result of the IRS' ability to pyramid the penalties within the Code. Punishment is often harshest for those taxpayers who attempt to correct their own tax filing errors. Companies which must file information returns on

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third parties find themselves facing large penalties for noncompliance even though they make good faith efforts to comply.

Congress must also consider the fairness of the present substantial understatement penalty. We must explore whether or not it is fair to penalize taxpayers strictly for failure to comply without proving intent. Also, we must consider the role of penalties in raising revenues for the federal deficit.

Finally, there is a serious question of whether or not the IRS is administering the present penalty structure judiciously and properly. From the testimony we will hear today, it seems the IRS lacks a consistent policy of implementation, resulting in significant regional differences. In addition, the IRS places a low priority on collecting data necessary in the administration of penalties. To use an analogy, I would find it difficult to believe that a major U.S. company would manage a comparable program so vital to its business mission without essential data collection to analyze the successes and failures of the program.

I would like to thank the witnesses testifying today. Most of them have travelled many miles and have devoted a substantial amount of time in order to share with us their knowledge on the subject of IRS penalties.

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DESCRIPTION OF TAX PENALTIES

Scheduled for a Public Hearing

before the

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

of the

SENATE COMMITTEE ON FINANCE

on

MARCH 14, 1988

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Committee on Finance has scheduled a public hearing on the subject of tax penalties on March 14, 1988. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an overview of the major penalties currently in the Internal Revenue Code, a discussion of some significant issues relating to the current penalty structure, and a listing of the penalties contained in the Code.

The first part of the pamphlet describes the major tax penalties under present law. The second part discusses background and significant issues concerning tax penalties. The Appendix presents a list of current tax penalties.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Tax Penalties* (JCS-4-88), March 9, 1988.

I. DESCRIPTION OF SIGNIFICANT PENALTIES

A. Overview

Tax penalties are generally designed to preserve the integrity of the tax system, and have been a component of the tax laws since the Revenue Act of 1913. Although the Internal Revenue Code includes a large number of penalties, only a relatively small number of these penalties are of general applicability. This portion of the pamphlet describes the more significant penalties of general applicability. The Appendix contains a listing of the tax penalties (including the penalty excise taxes) in the Code.

B. Negligence Penalty [2]

Under present law, a taxpayer is subject to a penalty if any part of an underpayment of tax is due to negligence or disregard of rules and regulations. The amount of this penalty is the sum of two components. The first component is an amount equal to 5 percent of the total amount of the underpayment of tax by the taxpayer (whether or not the entire underpayment is the result of the taxpayer's negligence). The second component is an amount equal to 50 percent of the interest payable on the portion of the underpayment attributable to negligence.[3]

For purposes of this penalty, negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code, as well as any careless, reckless, or intentional disregard of rules and regulations.

A special negligence penalty may be imposed with respect to information reporting. If an amount is shown on an information return and the payee or other person with respect to whom the return is made fails properly to show such amount on his or her income tax return, then the portion of any underpayment attributable to such failure is treated as subject to the negligence penalty absent clear and convincing evidence to the contrary.

In some instances, a taxpayer's return might lead to the imposition of both a fraud penalty and a negligence penalty. If an underpayment of a tax is partially attributable to negligence and partially attributable to fraud, the negligence penalty (which generally applies to the entire underpayment of the tax) does not apply to the portion of the underpayment with respect to which a fraud penalty is imposed.

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[2] Section 6653(a).

[3] A technical correction has been considered that would repeal the second component, and, in its place, impose interest on the penalty from the last date prescribed for filing the return to which the penalty relates.

C. Civil Fraud Penalty [4]

Tax fraud can render an individual liable for either civil or criminal sanctions, or both. An individual's actions that provide grounds for a civil tax penalty may also constitute grounds for criminal prosecution for willful attempt to evade or defeat tax.[5] Although civil tax fraud is not statutorily defined, it is generally considered to be intentional wrongdoing on the part of an individual, usually involving an element of deception, with the specific purpose of evading a tax due.

The Code provides that if any portion of an underpayment of tax is due to fraud, a civil penalty may be imposed equal to (1) 75 percent of the portion of the underpayment attributable to fraud, plus (2) an amount equal to 50 percent of the interest payable on the portion of the underpayment attributable to fraud.[6] Prior to the Tax Reform Act of 1986, the fraud penalty was 50 percent of the entire amount of the underpayment, if any portion of the underpayment was attributable to fraud. Thus, the 1986 Act reduced the scope of items to which the fraud penalty applied but increased the rate of the penalty.

Once the IRS establishes that any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, except to the extent that the taxpayer establishes that any portion of the underpayment is not attributable to fraud. Unlike most other civil penalties, the burden of proof is on the Government to establish that a portion of the underpayment is attributable to civil fraud. Once that burden has been met, the burden shifts to the taxpayer (who is presumed to have the best access to the information) to establish the portion of the underpayment that is not attributable to fraud.

D. Substantial Understatement Penalty [7]

If a taxpayer's correct income tax liability for any taxable year exceeds that reported by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations), then a "substantial understatement" exists and a penalty may be imposed equal to 25 percent of the underpayment of tax attributable to the understatement.

In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) in non-tax shelter cases, facts relevant to the tax treatment of the item were adequately disclosed on the return (or a statement attached thereto).[8]

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[4] Section 6653(b).

[5] Significant criminal penalties, including the criminal tax evasion penalty, are discussed below.

[6] A technical correction has been considered that would repeal this second component, and, in its place, impose interest on the penalty from the last date prescribed for filing the return to which the penalty relates.

[7] Section 6661.

[8] A special rule governs items "attributable to a tax shelter," meaning a partnership or other entity, plan or arrangement, the principal purpose of which is the avoidance or evasion of Federal income tax. In the case of such a tax shelter item, adequate disclosure on the return will

Continued

Whether the taxpayer's filing position is or was supported by substantial authority depends on the circumstances of the particular case. In order to determine whether the weight of authorities that support the taxpayer's position is substantial when compared with those supporting other positions, it is necessary to weigh statutory provisions, court opinions, Treasury regulations and official administrative pronouncements (such as published revenue rulings and revenue procedures) that involve the same or similar circumstances and are otherwise pertinent (giving each its proper weight), as well as the Congressional intent reflected in committee reports. The "substantial authority" standard is less stringent than a "more likely than not" (i.e., more than 50 percent) standard but more stringent than a "reasonable basis" (i.e., non-negligent) standard.

The IRS has discretion to waive all or part of the substantial understatement penalty if the taxpayer establishes that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith. A waiver could be appropriate, for example, if the taxpayer made a good faith mistake in deciding the proper timing of a deduction.

In determining the amount of the penalty to be imposed for a substantial understatement, no account is to be taken of any portion of the substantial understatement attributable to items on which the overvaluation penalty (*see next item*) is imposed.

E. Valuation Penalties [9]

If an individual, personal service corporation, or certain closely held corporations underpays income tax for any taxable year by $1,000 or more as a result of a "valuation overstatement," then a penalty may be imposed. A parallel penalty applies to valuation understatements for purposes of the estate and gift tax.

A "valuation overstatement" exists when the valuation or adjusted basis of any property claimed on the return is 150 percent or more of the correct value or adjusted basis. Thus, the penalty could be imposed as a result of claimed depreciation based on an inflated adjusted basis in property or claimed charitable contributions of allegedly appreciated property. If the valuation claimed is 150 percent or more but not more than 200 percent of the correct valuation, then a penalty may be imposed equal to 10 percent of the underpayment of tax attributable to the overvaluation. If the valuation claimed is more than 200 percent but not more than 250 percent of the correct valuation, then a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the overvaluation. If the valuation claimed is more than 250 percent of the correct valuation, then a penalty may be imposed equal to 30 per-

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not, by itself, reduce the amount of the understatement. Instead, the amount of the understatement is reduced by the portion attributable to a tax shelter item only if (1) the treatment of the item is or was supported by substantial authority, *and* (2) the taxpayer reasonably believed (based upon the taxpayer's analysis, or that of a professional tax advisor, of pertinent authorities) that the tax treatment claimed was more likely than not the proper treatment.

[9] Sections 6659 and 6660.

cent of the underpayment of tax attributable to the overvaluation.[10]

Both the valuation overstatement penalty and the negligence (or fraud) penalty may be applied with respect to the same underpayment. The IRS may waive all or part of the valuation overstatement penalty on a showing by the taxpayer that there was a reasonable basis for the valuation or adjusted basis claimed on the return and that the claim was made in good faith.

F. Penalties for Failure to File and Failure to Pay

Failure to file [11].—A taxpayer who fails to file a tax return on a timely basis is subject to a penalty equal to 5 percent of the net amount of tax due for each month the return is not filed, up to a maximum of 5 months or 25 percent. The net amount of tax due is the excess of the amount of tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of the tax. The amount of any applicable credit that may be claimed on the return also may be used to reduce the net amount of tax due.

In the case of a failure to file an income tax return within 60 days of the due date, the failure to file penalty may not be less than the lesser of $100 or 100 percent of the amount required to be shown on the return. In addition, if a penalty for failure to file and a penalty for failure to pay tax shown on a return apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return.

Failure to pay tax shown on return[12].—A taxpayer who fails to pay the amount of tax shown on a return is subject to a penalty of 0.5 percent of the amount of tax shown on the return for each month the amount remains unpaid, up to a maximum of 25 percent (50 months). For purposes of calculating the amount of the penalty for any month, the amount of unpaid tax liability is reduced by the amount of tax paid on or before the beginning of that month and by the amount of any credit that may be claimed on the return.[13]

Failure to pay tax after notice and demand[14].—A taxpayer who fails to pay an amount of tax required to be shown on a return that is not so shown within 10 days of notice and demand for such tax is subject to a penalty equal to 0.5 percent of the amount of tax stated in the notice and demand for each month the amount remains unpaid, up to a maximum of 25 percent (50 months). The rate of this penalty increases to one percent for each month the amount is outstanding after the IRS notifies the taxpayer that the IRS is going to levy upon the assets of the taxpayer.[15] The penalty is applied against the tax stated in the notice and demand, less any partial payments made by the taxpayer.

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[10] For purposes of the estate and gift tax, if the valuation claimed for property is 50 percent or more but not more than 66-2/3 percent of the correct valuation, then a penalty may be imposed equal to 10 percent of the underpayment of tax attributable to the valuation understatement. If the valuation claimed is 40 percent or more but less than 50 percent of the correct valuation, then a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the valuation understatement. If the valuation claimed is less than 40 percent of the correct valuation, then a penalty may be imposed equal to 30 percent of the underpayment of tax attributable to the valuation understatement.

[11] Section 6651(a)(1).

[12] Section 6651(a)(2).

[13] If the amount required to be shown as tax on a return is less than the amount actually shown as tax on the return, the penalty is based on the amount required to be shown as tax on the return.

[14] Section 6651(a)(3).

The IRS has discretion to waive the imposition of any failure to file or failure to pay penalty if the taxpayer's failure was due to reasonable cause and not willful neglect.

G. Information Reporting Penalties [16]

Under present law, the Code requires that information returns be filed with the IRS, and a copy be provided to the taxpayer, detailing all wages, most other types of income, and some deductions. These requirements apply to a variety of specific payments, and are described in a number of Code provisions.

The Code also provides civil penalties for each failure either to file an information return with the IRS or to provide a copy to the taxpayer. The general penalty for failure to supply an information return to the IRS is separate from the penalty for failure to provide a copy to the taxpayer. Generally, these penalties are $50 for each failure, with a maximum penalty of $100,000 per calendar year applicable to failures to file information returns with the IRS, and another maximum penalty of $100,000 per calendar year applicable to failures to provide copies of information returns to payees.[17]

If the failure to file information returns with the IRS is due to intentional disregard of the filing requirement, these penalties are imposed without an overall maximum. In addition, the amount of the penalty per return not filed is increased from $50 to $100 (or a higher amount for some types of information returns).[18]

The Code also provides a penalty[19] of either $5 or $50 (depending on the nature of the failure) for each failure to furnish a correct taxpayer identification number (for individuals, the social security number). These taxpayer identification numbers are the principal means by which the IRS matches the information reported by the third party with the taxpayer's tax return.

The Code also includes a penalty for failure to include correct information either on an information return filed with the IRS or on the copy of that information return supplied to the payee. This penalty applies to both an omission of information or an inclusion of incorrect information. The amount of the penalty is $5 for each information return or payee statement, up to a maximum of $20,000 in any calendar year. This maximum does not apply in cases of intentional disregard of the requirement to file accurate information returns. In addition, the amount of the penalty per inaccurate return is increased in cases of intentional disregard.

The penalty for the failure to include correct information does not apply to an information return if a penalty for failure to supply a correct taxpayer identification number has been imposed with respect to that information return.

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[15] Section 6651(d).

[16] Sections 6721-6724.

[17] These caps do not apply to failures with respect to interest or dividend returns (section 6724(c)(2)).

[18] For example, the penalty for failure to report cash transactions that exceed $10,000 is 10 percent of the amount that should have been reported.

[19] Section 6676.

In general, no penalty is imposed if the failure to file an information return with the IRS, to provide a copy to the payee, or to include correct information on either of those returns is due to reasonable cause and not to willful neglect.[20] Thus, under this standard, if a person required to file fails to do so because of negligence or without reasonable cause, that person would be subject to these penalties.

H. Estimated Tax Penalties

Individual [21].—Individuals must generally make quarterly estimated tax payments that equal at least 25 percent of the lesser of (1) 100 percent of the prior year's tax liability or (2) 90 percent (80 percent for taxable years beginning before January 1, 1988) of the current year's tax liability. For this purpose, amounts withheld from wages are considered to be estimated tax payments.

If an individual fails to make the required estimated tax payments under these rules, a penalty is imposed. The amount of the penalty is determined by applying the underpayment interest rate to the amount of the underpayment for the period of the underpayment. The amount of the underpayment is the excess of the required payment over the amount (if any) of the installment paid on or before the due date for the installment. The period of the underpayment runs from the due date of the installment to the earlier of (1) the 15th day of the fourth month following the close of the taxable year, or (2) the date on which each portion of any underpayment is made. No penalty is imposed if the amount of tax shown on the return (net of wage withholding) for any taxable year is less than $500.

Corporate [22].—Under present law, a corporation that fails to pay an installment of estimated income tax on or before the due date generally is subject to a penalty, which may not be waived. The amount of the penalty is determined by applying the underpayment interest rate to the amount of the underpayment for the period of the underpayment.

For taxable years beginning after December 31, 1987, the underpayment penalty with respect to any installment applies to the difference between payments made by the due date of the installment and the lesser of an installment based on (1) 90 percent of the tax shown on the return,[23] or (2) 100 percent of the tax shown on the preceding year's return. Exception (2) generally is not available to a large corporation, except that a large corporation can use that exception for purposes of making its first estimated payment for any taxable year. Thus, both large and small corporations may base their first estimated tax payment for any taxable year on 100 percent of the tax shown on the preceding year's return. A large corporation is defined as a corporation having at least $1 million of taxable income in any of the three prior taxable years. No penalty is imposed if the tax shown on the return for any taxable year is less than $500.

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[20] Higher standards apply with respect to interest or dividends returns (Section 6724(c)).

[21] Section 6654.

[22] Section 6655.

[23] Corporations may compute these installments as if the income already received during the year was placed on an annual basis if doing so reduces the amount otherwise required to be paid.

I. Tax Shelter Penalties

Promoting abusive tax shelters [24].—The Code imposes a penalty upon those who promote abusive tax shelters. The penalty applies to persons who organize, assist in the organization of, or participate in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if, in connection with such organization or sale, the person makes or furnishes either (1) a statement which the person knows or has reason to know is false or fraudulent as to any material matter with respect to the availability of any tax benefit alleged to be allowable by reason of holding an interest in the entity or participating in the plan or arrangement, or (2) a "gross valuation overstatement" (i.e., a representation of the value of services or property which exceeds 200 percent of the correct value and which is directly related to the amount of any income tax deduction or credit allowable to any participant) as to a matter material to the entity, plan or arrangement, whether or not the accuracy of the statement of valuation is disclaimed. Reliance by the purchasing taxpayer or actual underreporting of tax need not be shown.

The amount of the penalty equals the greater of $1,000 or 20 percent of the gross income derived or to be derived by that promoter or organizer from such activity. This penalty is in addition to all other penalties provided for by law.

The IRS may waive all or any part of the penalty in the case of a gross valuation overstatement upon a showing that there was a reasonable basis for the valuation and the valuation was made in good faith.

Aiding and abetting the understatement of tax liability [25].—The Code imposes a penalty on any person who aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document under the internal revenue laws which the person knows will be used in connection with any material matter arising under the tax laws, and which the person knows will (if used) result in an understatement of the tax liability of another person. This penalty, which is $1,000 for each return or other document ($10,000 in the case of returns and documents relating to the tax of a corporation), can be imposed whether or not the taxpayer knows of the understatement. The penalty can, however, be imposed only once for any taxable period (or taxable event) with respect to documents relating to any one person.

The aiding and abetting penalty applies only if the person is directly involved in aiding or assisting in the preparation or presentation of a false or fraudulent document that will be used under the tax laws, or directly "procures" a subordinate to do any act subject to this provision. The requirement that a person "know"[26] that a document will be used in connection with a material matter arising under the tax laws and the requirement that the person "know" that the document, if used, will result in an understatement of tax, were designed to limit the penalty to cases involving willful attempts to accomplish an understatement of the tax liability of a third party. Thus, for example, a tax advisor would not be subject to this penalty for suggesting an aggressive but supportable filing position to a client even though that position was later rejected by the courts and even though the client was subjected to the substantial understatement penalty. If, however, the tax advisor suggested a position he or she knew could not be supported on any reasonable basis under the law, the penalty could apply.

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[24] Section 6700.

[25] Section 6701.

The Government bears the burden of proof with respect to this penalty. Furthermore, this penalty generally is in addition to all other penalties provided by law except the penalty on income tax return preparers (discussed below). If either the return preparer penalty or the aiding and abetting penalty may apply with respect to any document, the IRS must choose which penalty to impose.

Failure to furnish information regarding tax shelters [27].—The person having principal responsibility for organizing a tax shelter must register that tax shelter with the IRS.[28] For purposes of this requirement, a tax shelter is defined as any investment with respect to which a person could reasonably infer from the representations made that, as of the close of any of the first 5 years, the ratio of deductions and 350 percent of credits to cash and other property invested is greater than 2 to 1. In order for the registration requirement to apply, a tax shelter must also be subject to Federal or State securities law requirements or must meet specified size requirements. The IRS will provide the person registering the investment a tax shelter identification number, which must be provided to each investor. The investor is required to include the number on his or her tax return.

The Code also provides a penalty for failure to register a tax shelter with the IRS or for filing false or incomplete information with respect to such registration. The penalty for failure to register is the greater of 1 percent of the aggregate amount invested in such tax shelter or $500. No penalty is imposed if the failure is due to reasonable cause.

The Code also provides that persons (such as promoters) who are required to furnish to investors an identification number and who fail to do so are subject to a penalty of $100 for each such failure.

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[26] This generally requires actual knowledge. This is a subjective test, which may result in difficulties in applying this penalty. It has been suggested that some of this difficulty could be reduced if the standard were objective. Thus, a person would be subject to penalty if the person reasonably should have known both that the return or other document would be used in connection with any material matter and that it would result in an understatement of tax liability.

[27] Section 6707.

[28] If the person principally responsible for organizing the tax shelter fails to register the shelter as required, then any person who participates in the organization of the shelter must register the shelter. A person who is secondarily liable for registering the shelter must register it not later than the day on which the first offering for sale of any interest in the shelter is made. In the event that persons who are principally and secondarily liable for registering a shelter fail to register the shelter, any person participating in the management or sale of the investment must register the shelter. Registration by the manager or seller does not relieve the organizer or promoter of liability for the penalties for failure to register.

Moreover, any investor who fails to include the number on his or her tax return is subject to a penalty of $250, unless the failure is due to reasonable cause.

Failure to maintain lists of investors in potentially abusive tax shelters[29].—Any person who organizes any potentially abusive tax shelter or who sells any interest in such a shelter must maintain lists of purchasers. A potentially abusive shelter is any tax shelter that is required to be registered with the IRS or that is of a type that has a potential for tax avoidance or evasion and is described in IRS regulations. Failure to maintain the required lists of purchasers subjects the organizer or seller of the tax shelter to a penalty of $50 for each name omitted from a list, up to a maximum of $100,000 in any calendar year. The penalty may not be imposed where the failure is due to reasonable cause and not due to willful neglect.

J. Return Preparer Penalties

Negligent or fraudulent preparation[30].—The Code imposes a penalty of $100 on an income tax return preparer for each return on which an understatement of tax is caused by the return preparer's negligent or intentional disregard of the Federal tax law. If any part of an understatement of tax is due to a return preparer's willful attempt to understate tax, a $500 penalty is imposed upon the return preparer.

For purposes of this penalty, the term "income tax return preparer" means any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of an income tax return or claim for refund.[31]

Failure to furnish copy to taxpayer or other information[32].—If an income tax return preparer fails to furnish a completed copy of a return or claim for refund to the taxpayer by the time the return or claim for refund is presented for the taxpayer's signature, the return preparer is subject to a penalty of $25 for each such failure, unless the failure was due to reasonable cause and not willful neglect.

A return preparer is also subject to a $25 penalty if the return preparer fails to furnish on a return his or her identifying number (generally his or her social security number). A $50 penalty is imposed for each failure (up to $25,000 for any return period) by a return preparer to retain for three years after the close of the return period a completed copy of the return or a list of the name and taxpayer identification number of the taxpayer for whom the return was prepared. These penalties do not apply if the failure was due to reasonable cause and not willful neglect.

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[29] Section 6708.

[30] Section 6694.

[31] A person is not an income tax return preparer merely because he or she (1) furnishes typing, reproducing, or other mechanical assistance; (2) prepares a return or claim for refund for his or her employer or for employees of the employer, provided the employment is regular and continuous; (3) prepares a return or claim for refund for any trust or estate of which that person is a fiduciary; or (4) prepares a claim for refund for a taxpayer in response to a notice of deficiency issued to the taxpayer by the IRS or under certain audit procedures.

[32] Section 6695.

In addition, if a return preparer endorses or otherwise negotiates a check issued to the taxpayer with respect to any income tax return which the return preparer has prepared, a $500 penalty is imposed with respect to each such check. This penalty does not apply with respect to the deposit by a bank of the full amount of the check in the taxpayer's account in the bank for the benefit of the taxpayer.

K. Criminal Penalties

Tax evasion [33].—The Code provides that any person who willfully attempts to evade or defeat any tax [34] imposed by the internal revenue laws shall be guilty of a felony and, upon conviction, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution. To convict a defendant under this section, the Government must prove [35] beyond a reasonable doubt: (1) an additional tax due and owing; (2) knowledge on the part of the defendant that an additional tax was due; and (3) an affirmative act taken by the defendant to willfully evade, or attempt to evade, the tax. Willfulness in this context means the "voluntary, intentional violation of a known legal duty." [36]

Willful failure to collect or pay over tax [37].—The Code provides that any person required to collect, account for, and pay over to the Government any tax imposed by internal revenue laws (e.g., an employer required to withhold and pay over Federal wage and FICA taxes) who willfully fails to do so shall be guilty of a felony and, upon conviction, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.

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[33] Section 7201.

[34] This includes any income, estate and gift, employment, or excise tax.

[35] The burden of proof is on the Government in all criminal proceedings.

[36] *United States v. Pomponio*, 429 U.S. 10, 13 (1976), *reh. denied*, 429 U.S. 987 (1976). This definition of "willful" is generally applicable to all criminal provisions of the Internal Revenue Code. *See United States v. Bishop*, 412 U.S. 346 (1973).

[37] Section 7202.

Willful failure to file return, supply information, or pay tax[38].—The Code provides that any person required to pay any estimated tax or tax, or required to file a return, keep records, or supply information, who willfully fails to do so shall be guilty of a misdemeanor and, upon conviction, shall be fined not more than $25,000 ($100,000 in the case of a corporation), or imprisoned not more than 1 year, or both, together with the costs of prosecution. A conviction under this provision may be based on a failure to act on the part of the defendant (e.g., a taxpayer's willful failure to file a return), whereas a conviction for tax evasion (discussed above) requires the Government to prove an affirmative act taken by the defendant to willfully evade tax (e.g., creating fraudulent documents).

False returns[39].—The Code provides that any person who willfully submits any false return, statement, or other document that contains a declaration that it is made under penalties of perjury, or any person who willfully aids or assists in the preparation or presentation of such a false return or document, shall be guilty of a felony and, upon conviction, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

The Internal Revenue Code contains additional criminal penalties that apply to other offenses.[40] In addition, the United States Code contains a number of criminal provisions of general applicability (e.g., conspiracy, false statement, and mail fraud) that may also apply to tax offenses.[41]

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[38] Section 7203.

[39] Section 7206.

[40] These are listed in the Appendix.

[41] Because of the general nature of these criminal provisions, they are not listed in the Appendix.

II. BACKGROUND AND ANALYSIS

A. Development of Penalty Structure

As the income tax laws have increased in scope and complexity over the past 75 years, so too have income tax penalties grown in number and complexity. In many ways, the growth of penalties is parallel to and results directly from the growth of the income tax laws. This growth also, of course, parallels the growth and increasing complexity of transactions in the underlying economy. Although the early income tax laws contained relatively few penalties as compared with present law, a number of the important issues arising out of the current civil penalty structure have existed for a number of years. This is perhaps best illustrated by developments involving the negligence and fraud penalties.

The negligence and fraud penalties were originally enacted as part of the Revenue Act of 1918 [42] and were part of both the 1939 Code and the 1954 Code. Although these were probably the most important civil penalties in the Code, several aspects of these penalties led to the development of additional penalties.

One important aspect of both of these penalties that has existed from the date of their original enactment is fault: the intent of the taxpayer is vital to determining whether the penalty applies in a particular circumstance. Indeed, an element of fault seems inherent to concepts of negligence or fraud.

The element of fault also created several difficulties. Disputes concerning these penalties revolved around the knowledge or state of mind of the taxpayer; in many instances, resolving these disputes was difficult. In addition, in some instances the taxpayer had taken a seemingly indefensible return position, but was not held subject to either the negligence or fraud penalties because the requisite element of fault could not be established. These difficulties led to the establishment of no-fault penalties, such as the substantial understatement or valuation overstatement penalties.[43] The latter penalties are imposed on the basis of the return position taken by the taxpayer, which can be established by objective evidence, as opposed to the more subjective element of knowledge or state of mind of the taxpayer.

Another aspect of the negligence and fraud penalties that led to the development of additional penalties is the ability of taxpayers generally to avoid the imposition of the negligence or fraud penalties if they reasonably relied on a competent tax advisor. This aspect of these penalties is closely related to the fault element: reasonable reliance on a competent tax advisor may mitigate or eliminate any element of fault on the part of the taxpayer.

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[42] Section 250(b) of Public Law No. 254, 65th Congress; February 24, 1919. The fraud penalty predates this Act, but the prior version was substantially different from the 1918 Act provision, which parallels present law.

[43] An element of fault may be relevant with respect to these penalties, in that the IRS has discretion to waive these penalties if the taxpayer establishes that (1) there was a reasonable basis or reasonable cause for the position claimed on the return and (2) the taxpayer acted in good faith.

The Code also includes penalties on return preparers. These penalties are not, however, coextensive with penalties imposed directly on taxpayers. The standards tend to be applied differently; behavior generally must be more egregious for a penalty to be imposed upon a return preparer. Also, the dollar amount of the penalties on return preparers is significantly lower than the level imposed under the general penalties. Thus, under present law, a return position that could be subject to a substantial penalty if the taxpayer completed his or her own return could escape penalty or be subject to a relatively minimal penalty if the return is completed by a return preparer.

Another factor that led to the development of additional penalties has been the failure by the IRS and the courts to apply the negligence and fraud penalties in some instances where their application would seem fully justified.

In one Tax Court case, for example, the taxpayer had kept detailed mileage records, required by his employer for reimbursement purposes, that indicated that his business use of a vehicle was approximately five percent of total use. On his tax return, the taxpayer claimed 70 percent business use, with no records to justify this claim. The Tax Court properly allowed only five percent business use. The Court did not, however, impose a negligence or fraud penalty.

In another Tax Court case, the taxpayer had kept detailed records so that he could be reimbursed by his employer, but claimed on his tax return approximately 35,000 miles of business use beyond what his records demonstrated, without any justification. No negligence penalty was imposed. In another case, the taxpayer produced a diary purporting to justify the claimed deductions. The Tax Court called the diary a "fabrication" and said that the taxpayer "was not telling the truth." The Court still permitted him a deduction, and did not impose the regular negligence or civil fraud penalty. Another taxpayer apparently claimed a deduction for business mileage that exceeded the total mileage shown on his odometer, but the Tax Court did not impose a negligence or civil fraud penalty.

In another Tax Court case, the taxpayer claimed that 89 percent of his main house was used exclusively for business purposes, and that his children were not permitted to use the living room, the dining room (which they called a conference room), or the family room, which contained a wide-screen television, but were restricted to several bedrooms, bathrooms, and one of the kitchens. (The house contained approximately 9,000 square feet and 40 rooms.) The Tax Court stated that the business usage was "substantially overstated" and imposed the negligence penalty. The fraud penalty was not discussed." [44]

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[44] In addition, these taxpayers owned three cars: a sedan, a station wagon, and a two-seat sports car. They claimed 100 percent business use of the sedan and station wagon, and testified that they plus their two children either used the two-seat sports car or rented a car for all personal driving. The Tax Court stated that this "defies belief."

Other developments in the Code, unrelated to the negligence and fraud penalties, have had an impact on the development of penalties. For example, during the 1980's a number of detailed information reporting requirements have been added to the Code. These information reporting requirements were added to improve compliance and the ability of the IRS to verify compliance with the tax laws. As the information reporting structure became more detailed, so did the parallel penalty structure.

The administration of the tax laws by the executive branch and the courts also has had an impact on the development of penalties. Relatively few prosecutions are undertaken each year for criminal fraud.[45] This increases reliance on the civil fraud penalty. Also, the difficulties experienced by both the IRS and the courts in administering fault-based penalties, such as negligence and fraud, led to the development of no-fault penalties.

Another administrative development that, at least indirectly, has increased the number of, and level of specificity in, penalties has been the increased difficulties experienced by the IRS and Treasury in promulgating guidance on the tax laws. For example, there has been a substantial backlog in issuing regulations during this entire decade. The resulting delay in providing administrative guidance often makes it desirable, when possible, to provide as much guidance as possible in the statute, thereby increasing the detail in penalty provisions (as well as tax provisions generally).

An example that illustrates many of these elements was the growth of abusive tax shelters in the late 1970's and early 1980's. This growth was attributable to a number of factors, such as the willingness of taxpayers to take aggressive return positions, shortcomings in the substantive law, and administrative delay by both the IRS and the courts in resolving shelter disputes. One of the early legislative efforts undertaken to deal with tax shelters was the imposition of penalties on shelter organizers and promoters. Although the imposition of these penalties did not deal with all aspects of the abusive tax shelter problem, it was helpful in both indicating the increasing level of Congressional concern with the problem and providing increased information to the Government on the extent of the problem. Although the importance of these penalties may have been eclipsed by the enactment of the passive loss rules in the Tax Reform Act of 1986, they were an important element in dealing with abusive tax shelters.

B. Theory of Penalties

Overview

Civil and criminal penalties are only one part of a legal system designed to encourage compliance with the tax collection process. Withholding of tax on many types of income, information reporting on many payments and expenditures, audit and collection procedures, taxpayer assistance programs, and patriotic and moral values also provide incentives for timely and accurate computation and payment of tax.

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[45] This may be due to lack of resources, prosecution of other crimes taking a higher priority, and the desire to prosecute only cases with a high likelihood of ultimate conviction.

In addition to having a deterrent effect, penalties can also be viewed as providing a just punishment for socially undesirable behavior, compensation to the Government for the cost of audit and detection, and an additional source of revenue for the Government. This portion of the pamphlet discusses the ways these theories may have shaped the current penalty structure.

A variety of penalties may be imposed under the Code upon taxpayers who understate their tax liability or fail to comply with the tax laws in other respects. In addition, penalties may be imposed upon persons who may not directly owe tax but have other responsibilities under the Code, such as submission of information returns or the accurate preparation of returns. The following discussion of the rationales underlying the penalty system generally applies to both taxpayers and other persons with compliance responsibilities.

Economic Deterrence

One widely held view of the purpose of penalties is that they provide appropriate incentives for taxpayers to comply with the tax laws. In this view, taxpayers rationally weigh the economic costs and benefits of tax compliance. Although social and moral influences also underlie a taxpayer's decision to comply, it may be useful to examine penalties solely within the framework of the economic incentives they generate.

The costs of compliance, from the taxpayer's standpoint, consist of the value of the taxes and other expenses paid as well as the effort required for timely and accurate compliance with the laws. The benefits to the taxpayer from compliance stem from negative consequences avoided. The negative consequences of noncompliance arise from the possibility that the taxpayer will be audited and identified as a noncomplier, the original tax liability plus interest and penalties will have to be paid, and criminal charges may be brought.

The expected benefit to the taxpayer of noncompliance equals the value of failing to pay tax without detection, minus the chance of being caught times the perceived costs, if caught. An increase in the probability of detecting noncompliance or an increase in the level of the potential penalty imposed generally will raise the incentive for compliance.[46] The deterrent effect of penalties is therefore integrally related to both the likelihood of detection and the severity of the penalties.

Under the economic deterrence view, higher penalties may substitute for a higher likelihood of detection. For example, information reporting and withholding on wages make detection of tax evasion on wages relatively easy; the likelihood of detecting the overstatement of business expenses may be much lower. It may still be possible to provide equivalent incentives for taxpayer compliance if the penalty on overstatement of business expenses is correspondingly higher than that for underreporting of wage income. To maximize taxpayers' incentives to comply, the relationship of penalties and detection suggests that information reporting, audit programs, and penalty structures should be considered simultaneously.

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[46] There may be situations where an increase in the penalty will have no impact because the incentive to comply is still too small or was already so large that there will be no additional impact on the incentive to comply.

A more complex or uncertain penalty structure may actually increase compliance relative to a structure that is simple and certain, if taxpayers are risk-averse. If a taxpayer correctly perceives the average level of penalties which may be imposed but is uncertain about the exact level of penalty which would be imposed in his or her specific case, the incentive for compliance may be greater than if the penalty level were certain. This is because the risk-averse taxpayer generally will respond more strongly, for example, to a 25-percent chance of being penalized $10,000 than a 50-percent chance of being penalized $5,000.

A more complex and uncertain penalty structure may, however, make it difficult for taxpayers to estimate accurately the average potential penalty. If taxpayers underestimate potential penalties, increasing taxpayer awareness of the costs of noncompliance will increase the deterrent impact of the penalties. Conversely, it may be in the Government's interest for taxpayers' perceptions to overestimate the average size of penalties since this will provide a larger incentive to comply.

Complexity and uncertainty about the application of the tax laws often raise the costs of compliance since the taxpayer may be unable to determine simply and accurately the tax due. Instead, complexity may force the taxpayer to retain more sophisticated advice which still may not be determinative.[47] Many argue that fairness dictates that penalties be less harsh in these situations, but a deterrence view would not necessarily lead to the same conclusion. The incentive to comply may be the same regardless of how complex the law. As long as additional resources and effort expended by the taxpayer will generate more accurate compliance, the incentive to comply will still be effective; it does not depend on the ability of the taxpayer to obtain easily the correct outcome.

Some take the view that the penalty structure should be used to encourage taxpayers to expend a reasonable effort to comply with the tax laws. Others argue that the true function of the penalty structure is simply to advance the end result of timely payment by the taxpayer of the correct amount of tax due. However, basing penalties on the results of the effort, i.e., the amount of tax understatement, while ignoring fault or the reasonableness of the taxpayer's position, may provide to the taxpayer the appropriate incentives to comply. It will usually be administratively easier for the Government to measure the amount of tax understatement than the efforts made by the taxpayer to comply.[48] The penalty structure in the Code embodies a mixture of both principles, since some penalty rates are based to a degree on determinations of the reasonableness of the taxpayer's position and effort applied in complying.

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[47] For example, the taxpayer may be able to request a private letter ruling from the IRS on the tax consequences of a particular transaction.

[48] Peculiarly, penalties based solely on effort would require the IRS to penalize taxpayers who paid approximately the correct tax but reached this result with insufficient care and diligence in order that appropriate effort incentives are provided to all taxpayers.

Social or Moral Deterrence

Another, complementary view of penalties is that they provide social or moral deterrence of inappropriate or socially undesirable behavior. The impact of tax penalties in this regard may be limited, primarily due to the fact that the imposition of penalties is not publicized, unless the penalties are contested in court.[49] The imposition of penalties may have a private moral deterrence value, which would be entirely dependent on the values of the taxpayer who is penalized.

Fairness

A different view of the purpose of penalties suggests they serve a purpose beyond promoting incentives for efficient compliance. Instead, penalties may be enacted because of fairness considerations, as just punishment for transgressions against societal standards. A view of penalties based purely on incentives suggests few reasons for limiting the size of penalties. Fairness considerations may, however, lead to limitations on the size of penalties. Few would consider it equitable to impose the same punishment on a murderer as on a tax cheat. Fairness demands the punishment fit the crime.

Most people believe that penalties should be roughly proportional to the degree of the violation. It may be difficult to follow this principle in actuality, however, because the nature of the violation varies considerably among taxpayers. The measure of the violation is usually based on the amount of tax underpaid, so that the penalty imposed is consequently proportional to the tax underpayment. If, however, the measure of the violation is the number of times an act is done or not done (such as failure to file information returns), the total penalty may well be viewed as disproportionate to the violation committed. Because of this, a cap on the amount of total penalty imposed may be viewed as equitable. In some circumstances, however, repeated violations may be viewed as justifying increased penalties.

The sheer size of a penalty may limit its effectiveness. If a penalty is viewed as too large or inappropriate for the particular violation, based on equity considerations, the IRS and the courts may hesitate to impose it. Once taxpayers recognize that the Government is unwilling to impose certain harsh penalties, a smaller, more enforceable, penalty might provide a greater deterrent effect. For example, certain violations of pension rules may result in the disqualification of the whole pension plan. This penalty is considered so draconian that it is rarely, if ever, used. A penalty more fitting to the particular violation, such as an excise tax on the dollar amount of the transaction that violated the tax rules, may prove more efficacious.

Equity considerations often lead one to consider the taxpayer's intent and efforts in complying instead of focusing solely on the amount of tax underpayment. The deterrence view instead suggests that the subjective intent of the taxpayer may not be particularly relevant for determining the level of penalties. Both views are reflected in different portions of the penalty structure of the Code. The negligence and fraud penalties, for example, require that fault by the taxpayer be demonstrated, which reflects the equity view of penalties. The substantial understatement penalty, on the other hand, is based on the return position taken by the taxpayer, and may be more reflective of the deterrence view of penalties.

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[49] By contrast, some other countries provide public lists of tax offenders, presumably with the intent of increasing the social stigma associated with tax violations.

In general, equity considerations limit the size and pattern of available tax penalties and thus may limit their ability to provide appropriate incentives for compliance. Consequently, increased detection efforts may be necessary to provide sufficient compliance incentives. Indeed, some argue that in order for the penalty system to be viewed as equitable, Government enforcement efforts must avoid the appearance of randomness by assuring that the detection of tax law violators is relatively certain.

Penalties as Compensation for Enforcement Costs

Another view of penalties is that they serve as compensation to the Government for the cost of finding and collecting the tax from the noncomplier. This view is related to the concept of a user fee in that the taxpayer is compensating the Government for the cost of its enforcement efforts.

Under the compensation theory, penalties would not be related primarily to the taxpayer's behavior that generated the Government's assessment, but rather to the Government's costs of detecting and collecting the underassessment. This could be achieved by assessing the additional tax and interest due as well as a service charge for the amount of various types of resources which were required to locate and determine the assessment. Doing so could conflict, however, with equity goals, in that charging taxpayers for the Government's costs, which are predominantly determined by the Government and are not necessarily proportional either to the tax due or to its costs with respect to similarly-situated taxpayers, may be viewed as unfair. This view of penalties is present, however, in certain penalty provisions. For example, certain criminal penalties under the Code require a convicted taxpayer to reimburse the Government for the costs of prosecution. In addition, the penalty for failure to pay taxes after notice and demand [50] doubles [51] after the IRS notifies the taxpayer that it will levy on the taxpayer's assets.[52]

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[50] Section 6651(a)(3).

[51] Section 6651(d).

[52] This was enacted in the Tax Reform Act of 1986 in place of a user fee proposed by the Administration that would have been dependent on the effort expended by the IRS in attempting to collect the tax. The Treasury Department document entitled "Tax Reform for Fairness, Simplicity and Economic Growth" (November 1984, pp. 406-408) contained a proposal to repeal the penalty for failure to pay taxes and replace it with a cost of collection charge approximately equal to the cost of collecting the delinquent taxes. "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity" (May 1985) also contained this proposal (pp. 112-113). The underlying rationale was that the cost of collecting delinquent taxes would, in effect, be borne by those who have delayed making payment, rather than by all taxpayers. The proposal also was designed to encourage taxpayers to pay delinquent taxes more promptly. In lieu of adopting this proposal, the Congress maintained the general structure of the prior-law penalty for failure to pay taxes, but increased the amount of the penalty once the IRS generally initiates more expensive collection methods. Thus, the rate of the penalty doubles after the IRS notifies the taxpayer that it will levy on the taxpayer's assets.

Penalties as a Revenue Source

Since most penalties assessed under the Code require the payment of additional money to the Government, penalties can be viewed as an additional revenue source beyond the regular tax imposed. The increase in the number of penalties in the last decade, combined with the continuing pressure for increased tax collections, have caused some to suggest that tax penalties are being used to collect revenue and not simply to promote compliance with the tax laws. Use of penalties in this manner may generate disrespect for the tax system and, ultimately, lead to a decline in the level of voluntary compliance.

It has been suggested by some that the changes made in 1986 to the penalty for substantial understatements of tax and the penalty for failure to deposit withholding taxes were motivated by a desire to raise additional revenue. The Omnibus Budget Reconciliation Act of 1986 increased the amount of these penalties effective for penalties assessed after the date of enactment. Because penalties generally are not assessed until a final determination of tax liability, which usually occurs after completion of the audit process, administrative appeals, and Tax Court review, the increased penalties may be imposed with respect to conduct that occurred prior to enactment. Consequently, it has been argued that the "retroactive" increase in these penalties may be unfair in that it could not deter conduct that occurred prior to the enactment of the penalty. However, some feel that the original penalty structure may have been unduly lenient and the penalties have been adjusted to punish violations more equitably.

Some may view penalties as a generally unseen tax, since penalties are not imposed upon (and are therefore not visible to) most taxpayers. On the one hand, since taxpayers who owe penalties commonly may be perceived as being guilty of misbehavior, there could be significant support for using penalties to raise additional revenue. On the other hand, some might consider the use of penalties, especially those unrelated to fault, for any purpose other than to promote compliance with the tax laws as inappropriate and unfair.

A related argument stresses the flexibility the IRS has in assessing penalties and negotiating settlements. Some argue that the IRS uses the threat of additional penalties as a tool to pressure taxpayers into accepting unfavorable settlements. Taxpayers, though convinced that their potential litigating position is sound, may accept a settlement to avoid the possible imposition of substantial penalties. A different view of the same process may characterize the IRS as fairly applying the tax laws to collect revenue efficiently. Like many parties involved in potential judicial proceedings, the IRS may be willing to bargain away a higher level of penalties in order to most efficiently utilize its resources in the enforcement of revenue laws.

C. Tabulations of IRS Penalty Assessments [53]

The changing level of penalties in the tax collection process is illustrated by data on the number and amount of civil penalties assessed by the IRS during fiscal years 1978 through 1986. Table 1 illustrates that while the number of penalties assessed annually has remained fairly stable since 1981, it has actually declined by over three million from 1984 to 1986. The total dollar amount of penalties assessed, however, has grown from approximately $1.3 billion in 1978 to nearly $7.0 billion in 1986. Similarly, the net dollar amount of penalties assessed (penalties assessed less abatements) has increased from approximately $1 billion in 1978 to $3.5 billion in 1986.

Table 1.—Number and Amount of Civil Penalties Assessed, Fiscal Years 1978–1986

Fiscal year	Number of penalties assessed (millions)	Amount of penalties assessed (billions)	Amount of net penalties [1] (billions)
1978	15.4	$1.3	$1.0
1979	20.8	1.6	1.2
1980	19.6	2.1	1.6
1981	22.1	3.0	2.1
1982	26.3	5.1	3.3
1983	25.2	4.6	2.4
1984	26.1	5.1	3.1
1985	22.0	5.7	3.0
1986	22.9	6.9	3.5

[1] Net penalties are penalties assessed during the fiscal year less penalties abated during the fiscal year.

Source: Various issues of the *Annual Report of the Internal Revenue Service.*

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[53] The statistical data on IRS penalty assessments contained in this section is derived from various issues of the *Internal Revenue Service Annual Report*. The IRS only began reporting penalties assessed separately from tax and penalties recommended after examination in the 1978 Annual Report. All references in this section are to fiscal years.

Table 2 provides data on the audit rate and the number of returns examined in the corresponding 1978 through 1986 period. Since 1978, the individual audit rate has declined by nearly a half and the corporate audit rate has fallen by two-thirds. The number of returns examined also has declined by over 40 percent during the same period. Despite the drop in audit rates and the number of returns examined, the number of penalties assessed has increased slightly and the dollar amount of penalties assessed has increased dramatically. This could be attributable to better targeting of enforcement resources, increased noncompliance of taxpayers, increased matching of information returns, the increase in the number of potential penalties, increased penalty rates, or a greater willingness by the IRS to impose penalties.

Table 2.—Individual and Corporate Income Tax Return Audit Rate and Returns Examined, Fiscal Years 1978–1986

Fiscal year	Individual audit rate (percent)	Corporate audit rate (percent)	Total returns examined (millions)
1978	2.16	8.01	2.4
1979	2.11	7.44	2.3
1980	2.02	6.48	2.2
1981	1.77	5.05	2.0
1982	1.55	4.73	1.8
1983	1.50	3.64	1.7
1984	1.27	2.66	1.5
1985	1.31	2.39	1.5
1986	1.10	2.25	1.3

Source: Various issues of the *Annual Report of the Internal Revenue Service*.

The data in Table 3 suggest that civil penalties also have increased in importance as an element of total revenue that is directly derived from enforcement activities. Penalties accounted for only 20·percent of the total additional tax and penalties assessed in 1978 but accounted for over 35 percent of additional tax and penalties assessed in 1986. The data in Table 3 also indicate that as a revenue source net penalties represent a very small portion, less than half of one percent, of total IRS collections. This percentage, though, is almost double that in 1978.[54]

Table 3.—Civil Penalties Assessed as a Percent of Additional Tax and Penalties Assessed and as a Percent of Total IRS Collections, Fiscal Years 1978–1986

Fiscal year	Penalties assessed as percent of additional tax and penalties assessed	Penalties assessed as percent of total IRS collections	Net penalties[1] as percent of total IRS collections
1978	20.65	0.32	0.24
1979	21.71	0.34	0.26
1980	22.32	0.41	0.30
1981	27.98	0.49	0.34
1982	43.05	0.80	0.52
1983	33.35	0.73	0.38
1984	35.20	0.74	0.46
1985	33.09	0.76	0.41
1986	35.94	0.89	0.45

[1] Net penalties are penalties assessed during the fiscal year less penalties abated during the fiscal year.

Source: Various issues of the *Annual Report of the Internal Revenue Service.*

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[54] The amount of penalties assessed does not represent the revenue gain to the Government because assessed penalties are often not collected. Because it is likely that the ability to collect penalties from taxpayers is considerably worse than for normal tax collections, the amount of assessed penalties actually collected as a percentage of total IRS collections is likely to be lower than Table 3 indicates. There is no available data indicating the amount of penalties assessed which are actually collected.

Table 4 contains data on the number and amounts of civil penalties assessed by type of return for 1986. Penalties assessed with respect to individual income tax returns (11.6 million penalties assessed) comprised over 50 percent of the total number of penalties assessed. Approximately 9.4 million (or 81 percent) of these penalties on individuals were estimated tax and failure to pay penalties. Nearly nine million employment tax penalties were assessed for the 1986 fiscal year, with the vast majority imposed for delinquency and failure to pay. Only 14 thousand civil fraud penalties, totaling $185 million, were assessed in 1986.

Table 4.—Number and Amount of Civil Penalties Assessed and Net Penalties, Fiscal Year 1986

[All values in millions]

Assessments	Number	Amount	Amount of net penalties[1]
Individual	11.620	$2,482.3	$1,592.4
Delinquency	1.579	552.6	406.0
Estimated tax	2.720	985.6	391.5
Failure to pay	6.714	365.9	310.4
Fraud	0.012	151.3	128.1
Negligence	0.229	245.8	199.2
Other	0.366	181.1	157.2
Corporate	0.954	1,507.1	587.1
Delinquency	0.164	598.5	175.2
Estimated tax	0.336	331.4	151.9
Failure to pay	0.432	383.9	110.6
Fraud	0.001	26.3	22.7
Negligence	0.004	28.9	26.5
Other	0.017	138.1	100.2
Employment	8.918	1,770.1	875.4
Delinquency	2.614	763.1	502.4
Failure to pay	5.182	376.8	190.8
Fraud	0.001	1.9	1.8
Other	1.121	628.4	180.4
Excise	0.921	249.5	70.6
Estate and Gift	0.027	91.2	2.8
All Other	0.369	560.5	169.7
Non-Return	0.106	267.6	217.2
Total, All Civil Penalties	22.914	6,928.3	3,515.2

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[1] Net penalties are penalties assessed during the fiscal year less penalties abated during the fiscal year.

Source: *1986 Annual Report of the Internal Revenue Service.*

D. Overlapping Penalties

In General

The civil tax penalty provisions of present law may be criticized for providing multiple penalties that may be imposed with respect to a single act or failure to act. One basis for this criticism is that the total dollar amount of all potentially applicable penalties may bear no relation to the conduct of the person that is subject to the penalties. In fact, the imposition of multiple penalties for civil tax purposes may result in total monetary penalties that greatly exceed the monetary penalties for comparable non-tax Federal offenses. The use of statutory caps for many penalties (see part F, below) may mitigate the harshness of these effects.

An additional criticism is that the extent of the overlap among certain penalty provisions is unclear to taxpayers and the IRS. Thus, if two or more penalties are intended to apply to a single act or failure to act, the uncertainty concerning the possible application of such penalties may reduce their intended effect in deterring objectionable behavior. Furthermore, to the extent that the IRS does not uniformly apply the same penalty or penalties to identical or substantially similar conduct, the penalty provisions can be criticized as unfair. On the other hand, however, some uncertainty is unavoidable if an element of judgment is involved in the imposition of a penalty (such as, for example, where there is a reasonable cause exception to a penalty).

Overlap of Understatement Penalties and Negligence/Fraud Penalties

As previously mentioned in parts I., B. and C. (above), taxpayers are subject to a penalty if any part of an underpayment of tax is due to negligence or fraud. In addition, Congress has recently enacted several penalties that apply to underpayments of tax without regard to whether the conduct of the taxpayer that led to the underpayment was negligent or fraudulent.[55] For example, the substantial understatement penalty generally applies if there is an understatement of tax for any taxable year that exceeds the greater of (1) 10 percent of the tax required to be shown on the return, or (2) $5,000 ($10,000 for most corporations). Similarly, the penalty for income tax valuation overstatements and the penalty for estate or gift tax valuation understatements generally apply to an underpayment of tax that is attributable to a valuation overstatement or valuation understatement that exceeds a specific percentage of the correct valuation.

Some have argued that it is inappropriate to impose the negligence or fraud penalty and an understatement penalty with respect to the same underpayment of tax because the understatement penalties were designed to apply without proving fault on the part of the taxpayer (which is a necessary element in proving negligence or fraud). On the other hand, it may be appropriate to permit the imposition of both penalties with respect to the same underpayment in appropriate circumstances, because the understatement penalties and the negligence and fraud penalties are targeted at different aspects of the taxpayer's behavior. Thus, imposing both penalties could be necessary in order to provide a sufficient deterrent to different elements of objectionable behavior by the taxpayer.

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[55] These "no fault" penalties, however, may be waived by the IRS if the taxpayer establishes that (1) there was a reasonable basis or reasonable cause for the position claimed on the return and (2) the taxpayer acted in good faith.

Overlap of Penalty for Aiding and Abetting Understatement of Tax Liability and Penalty for Promoting Abusive Tax Shelters

The recently enacted penalties for aiding and abetting the understatement of tax liability and for promoting abusive tax shelters also may be imposed with respect to a single act of a person. For example, an attorney who assists in the organization of a tax shelter by preparing an opinion with respect to the availability of tax benefits may be subject to the aiding and abetting penalty and the penalty for promoting abusive tax shelters if the opinion contains a false or fraudulent statement that the attorney knows will result in an understatement of tax. In addition, a person's conduct with respect to a single tax shelter may lead to the imposition of multiple penalties for promoting abusive tax shelters.[56]

The imposition of multiple civil penalties with respect to a single tax shelter may lead to a total amount of penalties that greatly exceeds the gross receipts or net income earned by the person from the shelter. It could be argued, however, that this result is appropriate given the fact that the activities of the person may result in an understatement of tax by a large number of taxpayers. One way to mitigate any perceived unfairness in this provision would be to provide an overall limit on the penalty, based on either gross receipts or net income. It is also possible that the application of the passive loss limitations contained in the Tax Reform Act of 1986 may significantly curtail tax shelter activities, thereby decreasing the incidence of tax shelter penalties.

E. Gaps in Current Penalty Structure

Despite the large number of civil penalty provisions provided under present law, in a number of cases penalties are not imposed with respect to undesirable conduct either because no penalty applies to the conduct or the IRS is reluctant to assert a penalty that may be applicable to the conduct. The IRS may be reluctant to assert an otherwise applicable penalty if the amount of the penalty greatly exceeds the amount of tax that is underpaid as a result of the undesirable conduct.

For example, it is understood that the IRS ordinarily does not assert a penalty for a non-willful failure to file an information return relating to distributions from profit-sharing and retirement plans because the only penalty that applies to such conduct is a $25 penalty for each day that the return is not filed.[57] In contrast, the penalty that generally applies to a non-willful failure to file other types of information returns is $50, regardless of the length of time that the return is not filed.

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[56] In *Waltman v. U.S.*, 618 F. Supp. 718 (M.D. Fla. 1985), the court held that the term "activity" as used in section 6700 refers to each sale of an interest in a tax shelter, and, consequently, a minimum $1,000 penalty could be imposed with respect to each sale. On the other hand, in *Spriggs v. U.S.*, 87-2 USTC Par. 9392 (E.D. Va. 1987), the court concluded that the term "activity" refers to the overall activity of promoting an abusive tax shelter, and, thus, only a single penalty may be imposed for all sales activities.

As an additional example of undesirable conduct where a penalty is not asserted, it is understood that the IRS ordinarily does not assert a penalty for a non-willful failure to file an information return with respect to the payment of fixed or determinable annual or periodical income to a nonresident alien or a foreign corporation. The only applicable penalty is the penalty for failure to file a tax return, which the IRS generally considers inappropriate for a failure to file an information return.[58]

Finally, it has been suggested that the current penalty provisions do not adequately address the failure of S corporations to file timely returns. Under present law, a partnership that fails to file timely a return or files a return that fails to show required information is liable for a penalty for each month (not to exceed five months) that the partnership return is late or incomplete. The amount of the penalty for each month is $50 multiplied by the number of partners in the partnership for the taxable year for which the return is due. There is no similar penalty that applies to S corporations.[59]

F. Caps on Penalties

Several of the existing civil tax penalties that relate to information reporting are capped at a specific dollar amount. For example, the total amount of penalties that may be imposed with respect to any calendar year for the failure to file certain information returns, the failure to furnish certain payee statements, or the failure to include a taxpayer identification number on certain returns or statements generally is limited to $100,000. Similarly, a $20,000 cap generally applies to penalties that may be imposed with respect to any calendar year for the failure to include correct information on certain information returns or payee statements.

The limitations on the total amount of penalties that may be imposed with respect to any calendar year do not apply in the case of returns and statements that relate to the reporting of interest, dividends, or patronage dividends. In addition, the $100,000 cap for the failure to file certain information returns and the $20,000 cap for the failure to include correct information on certain information returns or payee statements do not apply if the failure is due to intentional disregard of the filing requirement.[60]

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[57] Under the authority of section 6047, the IRS requires the filing of information returns on Form W-2P (statement for recipients of annuities, pensions, retired pay or IRA payments) and Form 1099-R (statement for recipients from profit-sharing, retirement plans, individual retirement arrangements, etc.). In addition, under the same authority, the IRS requires a copy of each Form W-2P and each Form 1099-R to be provided to the recipient of the annuity, pension, retired pay, IRA payment or total distribution. The only applicable penalty for the failure to file the information return or payee statement is contained in section 6652(e), which imposes a penalty of $25 for each day a return or statement required under section 6047 is not filed.

[58] Treas. reg. sec. 1.1461-2 requires withholding agents to (1) file an annual information return on Form 1042S with respect to each recipient of a payment of fixed or determinable annual or periodical income, and (2) provide a copy of the Form 1042S to the recipient of the income. This information is used by the IRS to verify that each withholding agent is deducting and withholding the correct amount of tax. In addition, the IRS compiles the information submitted on Form 1042S by country of residence of the recipient and supplies it to each country that has entered into a treaty with the United States that provides for the mutual exchange of information.

[59] The general $50 penalty for the failure to furnish payee statements applies to the failure of an S corporation to furnish a copy of information shown on the return to shareholders of the S corporation.

It has been suggested that the information reporting penalties should not be limited to a specific dollar amount because a limitation diminishes the effectiveness of the penalty where there has been a failure to properly file a large number of returns or payee statements.[61] By limiting the maximum penalty that may be imposed, the cost of complying with the filing requirements for any year may exceed the amount of the penalty for that year, and, consequently, there may be no incentive to comply with the filing requirement. Because, however, the total failure to file information returns may well be regarded as intentional, resulting in the inapplicability of any cap, this problem may not arise in actuality.

In addition, the limitations may be criticized for treating more favorably those persons that are required to file a large number of returns or payee statements. For example, a business that files 10,000 information returns containing incorrect information for any taxable year would pay an average penalty of $2 per return ($20,000 cap divided by 10,000 returns), while another business that files 50 information returns containing incorrect information for any taxable year would pay the full penalty of $5 per return.[62]

In response to the argument in favor of removing the cap on penalties, it has been suggested that the caps are necessary because otherwise filers could be subject to enormous penalties that are disproportionate both to the filer's conduct and to the penalties for many other Federal offenses. Absent a cap on penalties, the IRS may be reluctant to assert penalties of such magnitude.

If it is determined that caps are necessary, it may be appropriate to extend the applicability of the caps to returns and statements that relate to the reporting of interest, dividends, and patronage dividends (absent willfulness in the failure to file).

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[60] In the case of intentional disregard of the filing requirement, the amount of the penalty is generally increased to $100 per return.

[61] See, for example, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985), pp. 112-113.

[62] Section 6723.

APPENDIX: LIST OF TAX PENALTIES

This Appendix lists the penalties currently in the Internal Revenue Code. The table is organized by section of the Code ("Sec."). Next is the title of the section; a brief description of the penalty is included parenthetically if the title of the section is not self-explanatory. Finally, there is an indication of whether the penalty predominantly applies to individuals, to corporations, or to both. If the penalty relates to, is, or functions similarly to an excise tax, that is also indicated.

List of Tax Penalties Under the Internal Revenue Code

Code section	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
72(m)(5)	Special rules applicable to employee annuities and distributions under employee plans.	X			
72(o)(2)	Special rules for distributions from qualified plans to which employee made deductible contributions.	X			
72(q)(1)	10-percent penalty for premature distributions from annuity contracts.	X			
72(t)	10-percent additional tax on early distributions from qualified retirement plans.	X			
4701	Tax on issuer of registration-required obligation not in registered form.				X
4912	Tax on disqualifying lobbying expenditures of section 501(c)(3) organizations.				X
4941	Taxes on self-dealing				X
4942	Taxes on failure to distribute income				X
4943	Taxes on excess business holdings				X
4944	Taxes on investments which jeopardize charitable purpose				X
4945	Taxes on taxable expenditures				X
4951	Taxes on self-dealing				X
4952	Taxes on taxable expenditures				X
4953	Tax on excess contributions to black lung benefit trusts				X
4955	Tax on political expenditures of sec. 501(c)(3) organizations			X	X
4971	Taxes on failure to meet minimum funding standards				X
4972	Tax on nondeductible contributions to qualified employer plans.				X

4973	Tax on excess contributions to individual retirement accounts, certain 403(b) contracts, and certain individual retirement annuities.				X
4974	Excise tax on certain accumulations in qualified retirement plans.				X
4975	Tax on prohibited transactions (relating to pensions)				X
4976	Taxes with respect to funded welfare benefit plans				X
4977	Tax on certain fringe benefits provided by an employer				X
4978	Tax on certain dispositions by employee stock ownership plans and certain cooperatives.				X
4979	Tax on certain excess contributions (to a pension plan)				X
4979A	Tax on certain prohibited allocations of qualified securities				X
4980	Tax on reversion of qualified plan assets to employer				X
4981	Excise tax on undistributed income of real estate investment trusts.				X
4981A	Tax on excess distributions from qualified retirement plans				X
4982	Excise tax on undistributed income of regulated investment companies.				X
5601	Criminal penalties (relating to alcohol taxes)			X	X
5602	Penalty for tax fraud by distiller			X	X
5603	Penalty relating to records, returns, and reports (relating to alcohol taxes).			X	X
5604	Penalties relating to marks, brands, and containers			X	X
5605	Penalty relating to return of materials used in the manufacture of distilled spirits or from which distilled spirits may be recovered.			X	X
5606	Penalty relating to containers of distilled spirits			X	X
5607	Penalty and forfeiture for unlawful use, recovery, or concealment of denatured distilled spirits, or articles.			X	X

List of Tax Penalties Under the Internal Revenue Code—Continued

Code section	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
5608	Penalty and forfeiture for fraudulent claims for export drawback or unlawful relanding.			X	X
5609	Destruction of unregistered stills, distilling apparatus, equipment, and materials.			X	X
5610	Disposal of forfeited equipment and material for distilling			X	X
5612	Forfeiture of tax paid distilled spirits remaining on bonded premises.			X	X
5613	Forfeiture of distilled spirits not closed, marked, or branded as required by law.			X	X
5661	Penalty and forfeiture for violation of laws and regulations relating to wine.			X	X
5662	Penalty for alteration of wine labels			X	X
5671	Penalty and forfeiture for evasion of beer tax and fraudulent noncompliance with requirements.			X	X
5672	Penalty for failure of brewer to comply with requirements and to keep records and file returns.			X	X
5673	Forfeiture for flagrant and willful removal of beer without tax payment.			X	X
5674	Penalty for unlawful production or removal of beer			X	X
5675	Penalty for intentional removal or defacement of brewer's marks and brands.			X	X
5681	Penalty relating to signs (relating to liquors)			X	X
5682	Penalty for breaking locks or gaining access (relating to liquors).			X	X

5683	Penalty and forfeiture for removal of liquors under improper brands.			X	X
5684	Penalties relating to the payment and collection of liquor taxes.			X	X
5685	Penalty and forfeiture relating to possession of devices for emitting gas, smoke, etc., explosives and firearms, when violating liquor laws.			X	X
5686	Penalty for having, possessing, or using liquor or property intended to be used in violating provisions of this chapter.			X	X
5687	Penalty for offenses not specifically covered (relating of liquors).			X	X
5691	Penalties for nonpayment of special taxes relating to liquors			X	X
5761	Civil penalties (relating to cigars, cigarettes and cigarette papers and fibers).			X	X
5762	Criminal penalties (relating to cigars, cigarettes and cigarette papers, and fibers).			X	X
5763	Forfeitures (relating to cigars, cigarettes and cigarette papers, and fibers).			X	X
5871	Penalties (relating to machine guns, destructive devices, and certain other firearms).			X	X
5872	Forfeitures (relating to machine guns, destructive devices, and certain other firearms).			X	X
6038(b)	Information with respect to certain foreign corporations (penalty for failure to furnish).			X	
6038(c)	Penalty for reducing foreign tax credit			X	
6038A(d)	Information with respect to certain foreign corporations (penalty for failure to furnish).			X	
6038B(b)	Notice of certain transfers to foreign persons			X	
6039E(c)	Information concerning resident status	X			
6332	Surrender of property subject to levy			X	
6621(c)	(Higher rate of) interest on substantial underpayments attributable to tax-motivated transactions.			X	

List of Tax Penalties Under the Internal Revenue Code—Continued

Code section	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
6651	Failure to file tax return or to pay tax			X	
6652	Failure to file certain information returns, registration statements, etc..			X	
6653	Additions to tax for negligence and fraud			X	
6654	Failure by individual to pay estimated income tax	X			
6655	Failure by corporation to pay estimated income tax		X		
6656	Failure to make deposit of taxes or overstatement of deposits..			X	
6657	Bad checks			X	
6659	Addition to tax in the case of valuation overstatements for purposes of the income tax.	X			
6659A	Addition to tax in case of overstatements of pension liabilities.			X	
6660	Addition to tax in the case of valuation understatement for purposes of estate or gift taxes.	X			
6661	Substantial understatement of liability			X	
6672	Failure to collect and pay over tax, or attempt to evade or defeat tax.			X	
6673	Damages assessable for instituting proceedings before the Tax Court primarily for delay, etc..			X	
6674	Fraudulent statement or failure to furnish statement to employee.			X	
6675	Excessive claims with respect to the use of certain gasoline			X	X
6676	Failure to supply identifying numbers			X	
6677	Failure to file information returns with respect to certain foreign trusts.			X	

6679	Failure to file returns, etc., with respect to foreign corporations or foreign partnerships.			X	
6682	False information with respect to withholding	X			
6683	Failure of foreign corporation to file return of personal holding company tax.		X		
6684	Assessable penalties with respect to liability for tax under Chapter 42 (relating to private foundations).	X			
6685	Assessable penalties with respect to private foundation annual returns.	X			
6686	Failure to file returns or supply information by DISC or FSC		X		
6687	Failure to supply information with respect to place of residence.	X			
6688	Assessable penalties with respect to information required to be furnished under sec. 7654 (relating to coordination with income taxes of possessions).	X			
6689	Failure to file notice of redetermination of foreign tax			X	
6690	Fraudulent statement or failure to furnish statement to plan participant.		X		
6692	Failure to file actuarial report			X	
6693	Failure to provide reports on individual retirement accounts or annuities overstatement of designated nondeductible contributions.			X	
6694	Understatement of taxpayer's liability by income tax return preparer.			X	
6695	Other assessable penalties with respect to the preparation of income tax returns for other persons.			X	
6697	Assessable penalties with respect to liability for tax of regulated investment entities.		X		
6698	Failure to file partnership return	X			
6700	Promoting abusive tax shelters, etc.			X	

List of Tax Penalties Under the Internal Revenue Code—Continued

Code section	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
6701	Penalties for aiding and abetting understatment of tax liability.			X	
6702	Frivolous income tax return			X	
6704	Failure to keep records necessary to meet reporting requirements under sec. 6047(d) (relating to pensions).			X	
6705	Failure by broker to provide notice to payors			X	
6706	Original issue discount information requirements		X		
6707	Failure to furnish information regarding tax shelters			X	
6708	Failure to maintain list of investors in potentially abusive tax shelters.			X	
6709	Penalties with respect to mortgage credit certificates			X	
6710	Failure to disclose that contributions are nondeductible		X		
6711	Failure by tax-exempt organization to disclose that certain information or service available from Federal Government.		X		
6721	Failure to file certain information returns			X	
6722	Failure to furnish certain payee statements			X	
6723	Failure to include correct information (on information returns).			X	
7201	Attempt to evade or defeat tax			X	
7202	Willful failure to collect or pay over tax			X	
7203	Willful failure to file return, supply information, or pay tax			X	
7204	Fraudulent statement or failure to make statement to employees.			X	
7205	Fraudulent withholding exemption certificate or failure to supply information.	X			
7206	Fraud and false statements			X	

7207	Fraudulent returns, statements, or other documents			X	
7208	Offenses relating to stamps			X	
7209	Unauthorized use or sale of stamps			X	
7210	Failure to obey summons	X			
7211	False statements to purchasers or lessees relating to tax			X	
7212	Attempts to interfere with administration of internal revenue laws.	X			
7213	Unauthorized disclosure of information	X			
7214	Offenses by officers and employees of the United States	X			
7215	Offenses with respect to collected taxes			X	
7216	Disclosure or use of information by preparers of returns	X			
7231	Failure to obtain license for collection of foreign items			X	
7232	Failure to register or false statement by manufacturer or producer of gasoline or lubricating oil.			X	X
7240	Officials investing or speculating in sugar			X	X
7241	Willful failure to furnish certain information regarding windfall profit tax on domestic crude oil..			X	X
7261	Representation that retailers' excise tax is excluded from price of article.			X	X
7262	Violation of occupational tax laws relating to wagering—failure to pay special tax.			X	X
7268	Possession with intent to sell in fraud of law or to evade tax			X	X
7269	Failure to produce records			X	
7270	Insurance policies (relating to intent to evade the excise tax on foreign insurers).				X
7271	Penalties for offenses relating to stamps			X	
7272	Penalty for failure to register (relating to alcohol and tobacco taxes).			X	
7273	Penalties for offenses relating to (occupational stamp) taxes			X	
7275	Penalty for offenses relating to certain airline tickets and advertising.			X	

List of Tax Penalties Under the Internal Revenue Code—Continued

Code section	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
7304	Penalty for fraudulently claiming drawback			X	X
7341	Penalty for sales to evade tax			X	
7342	Penalty for refusal to permit entry or examination			X	

Statement of Gerald G. Portney

September 28, 1988

HEARINGS TO REVIEW THE CIVIL PENALTY PROVISIONS CONTAINED IN THE INTERNAL REVENUE CODE

Subcommittee On Private Retirement Plans And

Oversight Of The Internal Revenue Service

Mr. Chairman and Members of the Committee:

My name is Gerald G. Portney and I am a principal in the accounting firm of Peat Marwick Main & Co. I am here today at the request of the Committee, solely in my personal capacity and as a former careerist in the Internal Revenue Service for more than 26 years, which included the positions of District Director (1974-1979); Assistant Commissioner (Technical) (1979-1982); and Associate Chief Counsel (Technical) (1982-1983).

Anytime the Congress or any part thereof is receptive to examining what it has done and particularly in this most laudatory way, the public hearing process, our response as citizens should be to express our appreciation.

In addition, Mr. Chairman, your leadership in establishing a Task Force comprising a non-political, diverse group of volunteer citizens to carefully examine the penalty system, its fairness and effectiveness, is a further and also welcomed expression of concern.

Thank you for these reasons and also for your invitation to testify on the penalty system and the need for reform, both legislative and administrative.

I.R.S. Commissioner Gibbs has been quoted on a number of occasions as saying:

> If we had to pick a topic that single-handedly deserved the credit for raising the adversarial tension in the tax system, I submit that penalties would win more votes than any other subject.

Commissioner Gibbs also should be commended, not only for the accuracy of his statement and his candor in being public about it, but for the commitment he has shown in the Service's thoughtful efforts to produce meaningful analysis and concepts as a basis for change in the penalty system.

The current tax system is 75 years old, going back to the ratification of the Sixteenth Amendment to the Constitution in 1913. For the first 68 years, the philosophy of our system was based on voluntary compliance and self-assessment. For these last seven years the emphasis has shifted to detection and punishment. The traditional adversarial nature of the relationship between taxpayer and tax collector has too frequently become hostile.

The five major tax bills to date during the 1980's parallel in a sense the defense budget--both have produced a major increase in weapons. The difference between the two is the target of the buildup...in one, it is our enemies; in the other, it is our citizens, to whom the government looks for the support, the goodwill, and the trust necessary to enable a self-assessment system to function on a level at which it costs less than 50 cents for each $100 collected.

The buildup of the tax penalty arsenal in the 1980's to approximately 150 in number--not including sanctions in other forms, such as denial of deductions--was not an accident. It also was not thoughtful or coherent.

The 1975 study of penalties by the Administrative Conference of the United States is frequently quoted for its characterization of the then number of penalties (64) as "mind-numbing." By that standard, today's count should be characterized as mind-shattering.

How we achieved this dubious result may be helpful in at least an approach, if not to the solution itself.

I suggest there are two underlying causes for achieving a new high on the tax system equivalent of the Richter Scale and not offered in any order. First, the precedent established in the late 1970's on going public on the tax gap: its size, its components, its projected growth. We all knew that not every tax dollar due and owing to the United States Treasury was being paid. We knew the reasons: innocent, non-negligent mistakes that are an undisputed function of a highly complex tax system, made more so by frequent change; and all of this impacting upon a large, diverse population that has one common denominator--they are all human. At the other end of the spectrum, and arguably far fewer in number, are those who intentionally choose either not to be part of the system or who qualify their participation unjustifiably.

The second cause, in short--tax shelters. As tax shelters proliferated, more taxpayers got interested. Heretofore "honest" taxpayers who invested in shelters, abusive and otherwise, lost their halo of being good citizens

The tax gap and tax shelters became joined in the minds of some, resulting in a conclusion that tax cheating was a growing threat and that more and more "honest" taxpayers and tax advisers were crossing the line and that the answer was more penalties, larger penalties, and tougher penalties. There was and is a naive notion that penalties are only imposed upon those guilty of misconduct and that others need not be concerned. Those who subscribe to that belief assume that:

1. All the rules and regulations that apply to any given taxpayer are sufficiently clear and available to those affected and anything less than full compliance is punishable, and

2. People will not comply unless there is a significant downside risk (e.g. the "stick," as in the carrot and the stick).

Finally (and regrettably), Gramm-Rudman-Hollings and budget deficits have provided cover for those who have brought us this potential threat to the tax system disguised as penalties for the noncompliant.

To err is human, but to correct errors and misjudgments is feasible only if it does not lose revenue. So much for fairness. Are we to perpetuate mistakes based upon revenue estimates?

True reform and fairness require that Congress deal with the instances of overlap, duplication, and complexity and instances where the penalties are not consistent with the nature and degree of noncompliance.

High on the agenda for legislative reform of the penalty system is the presumption of guilt that is incorporated in the current language of the negligence penalty. This penalty is automatically assessed where in the I.R.S. matching program, there is an indicated discrepancy between the Service's records and the taxpayer's return.

Taxpayers who were included in the focus group sessions conducted by a private contractor as part of the I.R.S. civil penalty study resented the negligence connotation even where the dollar amount was not large. They considered themselves as basically compliant taxpayers. I suggest that the connotation and reaction to it would be widely shared by millions of compliant taxpayers.

Let's get rid of presumptive guilt. It is an abuse of administrative due process. It reinforces the public perception that when it comes to the I.R.S., the taxpayer is guilty. The standard of clear and convincing evidence is a legal standard of proof that is understood by few among the general population of taxpayers. For many, the options are (1) hire a lawyer, or (2) pay the penalty--it's cheaper. Presumptive guilt violates any sense of fairness.

It would be very useful if Congress were to launch a study of the cost of complexity to compliance with the tax system. It has the potential of shedding much more light on the issues of simplification and fairness and providing much needed criteria for future tax legislation.

In the meantime, there are some steps that can be taken that arguably will result in the following:

1. Improved compliance,
2. Increased revenues, and
3. Reduction in the adversarial tensions in the tax system.

Let's start with a moratorium on any further legislative changes in the penalty system, pending completion of studies and hearings. The following steps can then be implemented in the short term.

The threshold theme is that it should always be in the taxpayer's interest to find reporting errors and voluntarily act to correct such errors with the I.R.S. on a "sooner the better" basis. I refer to this as the policy on self-correction of errors.

The focus of this policy encompasses those who have made innocent mistakes (i.e., unintentional and non-negligent). ~~Where the I.R.S. finds the error first, it would be the~~ responsibility of the taxpayer to establish the innocent and non-negligent nature of the error. Those who can represent a record of consistent compliance would receive a bill from the I.R.S. showing what the penalty would have been, absent the good record, and marked "penalty waived." The taxpayer's file at the I.R.S. could be so noted.

The race would be on. The difference between this philosophy and the current one is that under this proposal, both the taxpayer and the I.R.S. would be trying to reach the compliance finish line with an added incentive to the taxpayer for getting there first.

Either on its own initiative or with the encouragement of Congress, the I.R.S. could launch implementation of this new policy by either publishing proposed rules and procedures for comment and hearing or seeking proposals for such rules and procedures from interested groups to be proposed for comment and hearing. The Service could take a useful step in this direction by holding field hearings in selected regions of the country to open the process even further outside the beltway. Let's take Washington, D.C. to where the taxpayers are.

I am convinced, based upon actual, frequent experiences in day-to-day practice, that such a policy, implemented with fidelity, would produce early and positive results in the form of increased compliance, increased revenues, and much-needed increased confidence in the tax system.

The companion proposal I offer is also one I feel strongly about, though it may take somewhat longer to conceptualize, design, debate, and adopt. Hopefully, this should not discourage its pursuit.

The proposal calls for the development of positive incentives for compliance. I referred earlier, in a passing way, to an age old but balanced approach known as the carrot and the stick. It recognizes that a good system has rewards and consequences or punishment.

The adversarial tensions to which Commissioner Gibbs refers, the attention that is being focused through the oversight process in both Houses of Congress, and the studies completed and to be completed by the Bar and others deal with the emphasis placed on the "stick" and the consequences thereof. The other side of that equation is the carrot. It is positive and probably too difficult for those whose view of our citizens, individual and corporate alike, cause them to think in terms of misconduct and punishment as the rule rather than the exception.

The proposal for self-correction of errors can be viewed as a positive incentive. It is also much more consistent with treating taxpayers as customers or constituents.

The area with the greatest potential for positive incentives is that of third-party information providers whose contribution to tax compliance through wage and information reporting is critical to its success.

Given the virtual (if not total) absence of positive incentives to comply, and given the substantial financial burden imposed upon payors for recordkeeping and reporting, the system is fortunate, indeed. But that in no way suggests it is working the way it should.

This administration has been an enthusiastic advocate of user fees for those who seek specified governmental services. Here, the government is requiring third parties to perform a compliance function for the sole benefit of the government. Should a reverse user fee be considered?

The financial service industries face particularly onerous burdens with equally onerous consequences for noncompliance.

One analysis done by a regional bank holding company on information reporting and penalties included this statement:

> A review of the penalty provisions of the Code will reveal that, if you count every penalty which may be applied to every form which a financial institution files, there are over 100 opportunities for an institution to err in the information reporting area.

While I have not taken the time to personally verify that statement, I have no reason to doubt it.

A starting point toward positive incentives would be a meaningful reform of the current negative incentives.

A thoughtful, philosophical beginning toward a solution to this problem is found in the I.R.S. discussion draft (6/8/88) entitled, "A Philosophy of Civil Tax Penalties," which provides, in part:

> The information return system relies largely on the furnishing of accurate information by third parties. Because the tax system depends on the accuracy and timeliness of the information provided, the government should work with payors to encourage long-term compliance with these rules. The Task Force believes that penalties should not be a mechanism of first resort in achieving compliance. If a payor is trying to comply and has instituted reasonable business practices to assure compliance, penalties may not be appropriate. Rather, IRS should focus on educational efforts and other mechanisms for equipping and encouraging payors to accurately and timely provide needed information. Penalties, however, will still be an essential fixture to provide a necessary sanction for those who are otherwise unwilling to establish adequate systems, or who otherwise would choose not to comply because it would not be worth the expense to comply. (P.20)

I was on the other side of the withholding debate in 1982 and 1983. I thought withholding was the right answer then and still believe it. But I also believe the memories of the withholding battle are in the way of reforming the information return system and the sanctions thereon. In the meantime, the burden continues on taxpayers and payors, alike.

There is much talent among the tax staffs in Congress and the Treasury. The challenge is to channel that talent toward positive change in the penalty system and to send a much needed message to the American public, that there is a helping hand for those who are making the effort to comply. The I.R.S. can proceed now to alter its administration of the penalty system. It knows where the problems are that can be solved administratively.

This Committee's support in that direction is vital.

There are many in the private sector who support the goal of improved tax compliance and would be pleased to join with those in government to further progress towards that goal.

I appreciate the opportunity of being part of this process and commend you, Mr. Chairman, for your leadership in the task of improving the functioning of our tax system for the benefit of all our citizens.

TESTIMONY OF CRAIG RHYNE,

PRESIDENT, RHYNE PRECIOUS METALS

SEATTLE, WASHINGTON

BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS

AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

SENATOR DAVID PRYOR, CHAIRMAN

WEDNESDAY, SEPTEMBER 28, 1988

Mr. Chairman and members of the Subcommittee, my name is Craig Rhyne. I am here as a member of the Board of Directors of the Industry Council for Tangible Assets, the national trade association of bullion and rare coin dealers headquartered here in Washington. I also serve as President of the Washington State Coin and Bullion Dealers Association, and as President of my firm, Rhyne Precious Metals.

I appear today to urge this panel to take action to relieve those in my business of onerous, arbitrary, confusing and possibly illegal IRS reporting requirements.

Approximately five thousand small businesses in the nation buy and sell precious metals and rare coins. Some concentrate more in the rare coin business; some in the precious metals. Most overlap to some degree.

The primary service that my firm offers is to provide gold, silver and other precious metals to those who wish to diversify their investments into more tangible assets because of counter-cyclical nature of these investments, or as an inflation hedge. The most commonly purchased gold investment is the one ounce U. S. gold Eagle.

Because of the large number of dealers and the nature of the product -- the gold I sell is the same as my competitors -- the profit margin tends to very small. I will show that the broker reporting requirements not only hurt the legitimate dealer, but deprive the federal government of significant revenues.

First, a little bit of background. In accordance with the TEFRA bill of 1982, brokers were instructed to file 1099(b) information reports in conjunction with the purchases from individuals of certain personal property--property that the Commodity Futures Trading Commission regulates. The goal was to curb alleged abuses of those who would avoid capital gains taxes.

Initial regulations published were extremely burdensome, and would have even required the filing of a 1099b if a rare coin dealer purchased an Indian-head penny from a young collector for a couple of dollars. In proposed regulations issued in 1984, at least coins valued over 15% over their metal value would be exempt. Of interest, is that the '84 proposed regulations have never been finalized, and as a result there is no consensus as to whether there are extant requirements or what those reporting requirements are.

In other words, we do not know what is actually required. But, we do know that it costs money to record the data and file it with the IRS.

In order to find out just how much a small-to-medium sized firm would be burdened by filing requirements, I hired the Seattle CPA firm of Moss-Adams. They studied carefully the time requirements, computer requirements and related costs of filing. The figures they came up with were lower than I expected, but very significant, nevertheless.

For the average transaction, broker reporting requirements would add $2 of labor costs, and $8 of costs related to inputting information in a computer, the costs of the computer, the transference of the data to IRS's desired magnetic media.

Of course, the costs would go down for large firms, as they can amortize their computers over more transactions. Parenthetically, what that means is that larger companies are given a competitive cost advantage by these regulations--small businesses bear a larger cost.

Now given an average of $10 cost per transaction of the broker reporting requirements, what does that do to the profitability of my business.

In charts following my comments, there are detailed cost figures, but the bottom line is this: profit margins are so small on smaller gold investments that the cost of the regulation far exceeds the profits until after gross sales exceed $2000.

Let's take the case of an investor might wish to sell ten one ounce Eagle coins. His return would be approximately $4,175. In such a case, the gross profits after all allocable costs would be $25.07. The added costs of the Broker Reporting forms would cut that down to $15.07 or a profit reduction of 40%.

A sale of 20 ounces of gold would normally yield a profit of $ $62.72. Broker reporting requirements would still be $10 for a profit reduction of 17%.

Most sales by individuals to businesses like mine are in the lower range of these examples: five to ten ounces, rather than twenty and up. Still, let us assume that this would reduce marginal profits by 25% -- not 40%. In that

In a generally profitable business, the reduction of profits on sales also means a reduction in the federal income taxes on that firm. Assuming the corporate income tax rate of 34%, that means that for every dollar profits declined, the federal government's revenues declined by 34¢. Putting it another way, if a small business that now has $100,000 in taxable earnings, broker reporting requirements would force profits would be down to $75,000. His taxes would decline from $34,000 to $25,500. In other words, for this one dealer, the broker reporting requirements would cost $8,500 in lost tax revenues.

If Congress had to appropriate the funds that it would lose in revenues from universal conformance with the proposed regulations, there would be some tough questions asked. Though I can not give you firm costs for the entire industry, if it would affect all five thousand dealers and the average was as is in my estimate (probably a high estimate), then there would be a revenue loss of $42,500,000 per year. That estimate is very high, I think, because many dealers would go out of business, and the increased costs would reduce the overall quantity of business conducted.

It is important to add here, that even if the lost revenues as a result of industry-wide conformance were half that high, there is still no possibility that there is that much lost tax reveunes from under reporting of capital gains--losses that would be curbed or discovered by the universal use of the proposed regulations.

My colleagues and I sympathize with the legitimate public policy goal of curbing tax evasion through the non-payment of capital gains taxes. But I will disclose some added facts about the precious metals market. The prices of gold and silver have not been going up, and all the record keeping that we might do will document mostly capital losses, not gains. They havn't had many gains. In recent years, Mr. Chairman, my customers have not under-reported their gains.

What is the IRS doing today? The answer depends on the region of the nation you're talking about. In some parts of the nation, there seems to be no enforcement. In others, there seems to be spotty, and capricious enforcement. Ironically, in two cases we are familiar with, the enforcement agents do not seem to be seeking to discover unreported capital gains. Rather enforcement of the proposed regulations are used merely used as a means of disciplining a dealer. One dealer reported, for example, that the IRS agent told him: "if you refile your old records, I want every transaction over $100 but, if I have to go through it, I'll want everything over $50 in value.

One dealer in Nevada dutifully filed boxes of 1099b forms. He was asked by the local IRS officials to file these on "magnetic media" and he sent them to a company in Los Angeles and paid $8,000 to have them put on "magnetic media." When he got them back, there was no question as to his cooperation, or accuracy but he was fined $50,000 for late filing.

Another dealer in the northwest was fined $5000 in spite of the fact that his accountant was told by two separate IRS office (Medford and Tacoma) that his client was not a "broker" and thus not required to file. In fact many dealers are in the same situation.

I have a letter for you, Mr. Chairman, from Robert T. McIntire from Jacksonville, Arkansas which says in part, "This IRS reporting requirement is going to put me and many other small businesses out of the business of buying and selling U. S. gold and silver coins and other bullion coins. This is a hobby-related business and we don't need this overhead ... to our many other problems. I can not afford the IRS magnetic reporting system and/or making reports on all the silver and gold coins that we handles weekly for the small profit we make.

Bob McIntire also cites profit margins similar to those contained in the study I am submitting for the record. These are in the range of 1-2%: somewhere in the profit range of a discount food warehouse: not a lot of money.

Mr. Chairman, what we seek is equitable treatment. First, we seek a redefinition of "broker." If an individual comes into my store and wishes to sell me an American Eagle coin which I intend to hold as inventory for resale, I am not acting as a broker.

Secondly, we seek treatment under the same rules which we now use in conjunction with currency trades: we must report all sales over $10,000 (or sales done in conjunction with one another).

Thirdly, we urge that the Treasury be required to live up to their obligations under the Administrative Practices Act which requires federal agencies to make provisions for the effects of their regulations on small business. The 1983 and 1984 regulations did not conform to this legislative requirement.

Fourthly, because of the confusing nature of the regulations we urge that the IRS be banned from seeking to impose penalties for noncompliance with the proposed and promulgated '83 and '84 regulations.

Mr. Chairman, I would be glad to answer any questions now or in writing later, and I know we would be glad to work with you and your staff to provide any added technical information about our industry and how we can work to provide information the government legitimately needs without undue burdens on our industry.

Thank you for your consideration.

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December 30, 1986

Mr. Craig Rhyne
Rhyne Precious Metals, Inc.
110 Cherry Street, Suite 202
Seattle, WA 98104

Dear Mr. Rhyne:

You have asked us to comment on a series of computations you have made (attached) regarding the increased cost to a "model" company of proposed regulations requiring 1099 forms to be submitted to the Internal Revenue Service on bullion purchase transactions. The model you have prepared had purchase transactions of $5,375,140. In order to determine the incremental transaction cost, we divided the purchases by an average gold price of $433 an ounce. This simple procedure indicates that approximately 12,400 ounces of gold (or gold equivalents, i.e., silver, platinum, etc.) were purchased by the company during the year. Using the assumptions you provided regarding the size of those transactions, we compute that the total number of transactions was 2,504. The number of transactions in each purchase size are summarized as follows:

	Transactions	Approximate Dollar Amount Of Each Transaction
One ounce	1,240	$ 433
Five ounce	868	2,165
Ten ounce	248	4,333
Twenty ounce and larger	148	N/A
	2,504	

Using your assumption that the annual cost to computer process the volume of transactions involved would be approximately $20,000, the incremental cost per transaction for the computer cost alone would be $8 ($20,000 divided by 2,504 transactions). You have also indicated you believe additional direct cost of approximately $2 per transaction would be incurred for the additional time of taking information from the customer, explaining the Form 1099 requirements to the customer, keypunching the information into the computer system, and the related form cost, data processing run cost, and postage.

Using these assumptions and other information provided by you, we have prepared a short table to outline the potential effect on profitability for the one, five, and ten ounce transactions.

	Transaction Size		
	One Ounce	Five Ounce	Ten Ounce
Average margin to dealer	$ 8.50	$38.25	$72.25
Less current direct cost:			
Salesperson	1.42	1.42	1.42
Paperwork	1.02	1.02	1.02
Hedging	2.16	10.80	21.60
Shipping	1.95	3.95	6.45
Current margin available to cover overhead	1.95	21.06	41.76
Incremental cost of Form 1099			
Computer overhead	8.00	8.00	8.00
Transaction cost	2.00	2.00	2.00
Margin available to cover existing overhead cost after Form 1099	$ (8.05)	$11.06	$31.76
Overhead before 1099 regulation	16.69	16.69	16.69
Net profit (loss) before taxes	$(24.74)	$(5.63)	$15.07

Mr. Rhyne, on a transaction basis, the margin of profit on one ounce transactions would become a loss (even without the incremental overhead) and the margin on five and ten ounce transactions would be reduced by 47 and 24 percent, respectively if you are required to file 1099 forms on such purchases. The impact on the model company would be significant; and the smaller the operation, the greater the impact would be because the smaller transaction sizes are a much greater portion of purchases for these enterprises.

Another way of approaching the impacts caused by the regulations would be to look at the overall effect on profitability rather than on a per-transaction basis. In the model operation that you have presented, the net profit before taxes was approximately $75,000 before 1099 regulations. The following analysis summarizes the impact of the regulation on the overall financial ability of the enterprise to make a profit.

	Amount
Before tax profits - before regulation	$75,000
Additional overhead (computer cost) caused by regulation	20,000
Additional transactions cost	5,000
Net profit after regulation	$50,000

As you can see, profit would be reduced by approximately one-third and this does not take into account the loss of small transactions due to a requirement for the Form 1099s and that such a requirement would necessitate increasing your fees on these transactions.

Since the greatest part of the cost associated with this regulation occurs because of the large number of small transactions, perhaps a more reasonable approach would be to require 1099's on only transactions exceeding a certain level, i.e., $10,000. This would limit the 1099's required in the model operation to less than 150 which could probably be processed manually without substantially increasing the costs of additional people or computer capability required to manage the volume of smaller transactions. The problem is that any reporting level less than this amount places undue hardship on the small to medium-sized dealers who facilitate transactions for the "little investors."

Another point to consider is that this analysis is not representative of the large brokerage houses that already have the systems to comply with the 1099 regulations at a minimal cost. You have indicated that these operations process a significant volume of the total transactions. Perhaps regulation should be applied by the type of purchaser rather than the size of transactions. It also seems that this may be where the potential for the greatest amount of unreported net income may exist since gold is a very low margin commodity and much of the assets held have high tax basis due to the market in the early 1980's.

And, of course, none of the above analysis presumes to account for what a fair return to the business should be given the risks of business and the volatile precious metals market.

Sincerely,

Charles E Pietka

Charles E. Pietka

CEP/rpr

Attachment

MEDIUM-SIZED BULLION DEALER PROFIT STUDY OF BUY-BACK TRANSACTIONS

DECEMBER 18, 1986

The precious metals investment business typically operates with very narrow profit margins; 1% to 2% on the buy back of coins or bars. For this reason, most precious metal "investment" firms/brokerages have large minimum orders, i.e., 10 ounces or 20 ounces of gold. The sample transactions below assume that the dealer will resell the merchandise purchased from a retail customer to a major wholesaler. Although quantities of coins or bars purchased retail from customers can sometimes be resold to another retail customer, this is not the normal occurrence. Also, small dealers cannot afford to hold any substantial amount of inventory and must immediately resell it to the wholesaler.

When overhead is considered, most dealers cannot be profitable on small transactions. They only take such orders as a "loss leader" because the client may decide to conduct a much larger transaction another time or he (she) may refer other people to do business.

Examples of various-sized purchases of American Eagle Gold Bullion Coins (loz. variety)

(Prices are based on the unfabricated price of gold (spot price) at $406.00 per ounce.)

1. Order size	1 oz.	5 oz.	10 oz	20 oz.
2. Average Commission charged	2.0 %	1.8%	1.7%	1.6%
3. Wholesale Bid on Coin(s)	$425.00	$2,125.00	$4,250.00	$8,500.00
4. Less Coin Dealer Gross Profit(a)	$(8.50)	($38.25)	($72.25)	($136.00)
5 Net eturn to etail Customer	$416.50	$2,086.00	$4,177.75	$8,364.00

Profit/Loss Analysis

6. Dealer Gross Profit per transaction	$8.50	$38.25	$72.25	$136.00
7. Less Direct Cost:				
A. Salesperson cost (b)	$1.42	$1.42	$1.42	$1.42
B. Paperwork cost (c)	$1.02	$1.02	$1.02	$1.02
C. Hedging cost (d)	$2.16	$10.80	$21.60	$43.20
D. Merchandise shipping cost (e)	$1.95	$3.95	$6.45	$11.45
	($6.55)	($17.19)	($30.49)	($57.09)

Order size	1 oz.	5 oz.	10 oz.	20 oz.
8. Gross Margin available before overhead	$1.95	$21.06	$41.76	$78.91
9. Cost of 1099 eport (f)	($10.00)	($10.00)	($10.00)	($10.00)
10. Margin left after 1099	($8.05)	$11.06	$31.76	$68.91
11. Overhead (indirect costs) (g)	$16.69	($16.69)	($16.69)	($16.69)
12. Net Profit (Loss)	($24.74)	($5.43)	$15.07	$52.72

FOOTNOTES

a. Commission at many firms is much less than this example, i.e., 1/2% - 1%. This cost/profit analysis is based on an actual medium-sized coin dealer (ten employees), which is a representative member of the Industry Council for Tangible Assets (ICTA) with retail bullion purchases of $5,375,140 last year. The company made a profit of $75,290 before Federal income tax during this period.

b. Salesperson's time: 8 orders per hour for 6 hours per day for 22 business days per month @ $1,500/month salary + $1.42 per transaction (same for sale as for purchase).

c. Normal costs: confirmation form cost = 10¢; envelope & postage cost = 32¢ (to mail out confirmation); data entry = 10¢; and bookkeeping cost (handling, deposit, etc.) = 50¢

d. Most dealers use the commodity futures market to "hedge" against the swings in the price of gold (and consequently, their inventories). Metals purchased from customers must be immediately sold or hedged to avoid loses. Approximately 5% of retail purchases require hedging, which equals $268,757, for this model from. The hedging cost, minimally estimated as one years @ 10% per year on those purchases = $26,875.70. For estimation purposes, we will convert all purchases into ounces of gold (12,400 ounces). This indicates the hedging cost per ounce is $2.16.

e. This assumes the gold was purchased from a retail customer then resold into the wholesale market, necessitating shipment of the coins to a New York or Los Angeles major wholesaler/distributor. Shipping costs: mailing label = 10¢; insurance and registered mail = 50¢ per ounce ($1.45 fixed cost plus insurance/mail cost of 50¢ per ounce).

f. Preparation of 1099's would necessitate the hiring of another accounting person(s) and/or the purchase or purchase or lease of a computer system. This study assumes no additional employees but the installation of a new computer system to store all old transactions, requiring creation of an "account" for every customer. Costs for a manual system would probably be similar. Estimated annual leasing cost of a computer system and software = $20,000. Forms costs, data entry, related staff time and postage = $2.00 per order. A computer for a 10-person firm with retail purchases totaling $5,375.140 of precious metals would cost a minimum of $20,000. Therefore, the cost to keep records provide information for a 1099 reporting per ounce of gold purchased retail in this example would be approximately $8.00 ($20,000 ÷ 2,504) + $2.00 for forms/data entry per above.

g. Overhead (indirect costs) are those costs not directly attributable to a specific transaction i.e., administration, advertising, depreciation, bad debts, local and state taxes, rent, utilities, accounting, legal, phones, insurance for high value and hold-up insurance, etc.
Overhead for this firm's building business last year was $417,233, of which approximately 90% can be attributed to its sales and 10% ($41,723) to its purchases. There were 2,504 retail purchases made, which indicate the overhead per transaction was approximately $16.69. No consideration has been made in this analysis for normal dealer profit justified by the business risk of capital taken by dealer. Return on investment or other opportunity costs have not been considered in this example.

SUMMARY: Because physical bullion transactions (as opposed to certificates) require costly safekeeping and other overhead, and because profit margins are so small, most dealers are only slightly profitable on purchase transactions of five (5) ounces gold (i.e., $2,000) even without an IRS 1099 report requirement. This means they are not profitable on purchase transactions smaller than $2,000.

If 1099 forms are required on purchases, the added cost makes the dealer unprofitable on a purchase of less than (10) ounces of gold (i.e., $4,000). Further, when the cost of 1099 forms is considered on a purchase of twenty (20) ounces gold (i.e. $8,000), the dealer's net profit is reduced from about $62.72 on an $8,364 transaction (0.75%) to $52.72 (0.63%).

CONCLUSION: If 1099 forms are required, a $10,000 de minimus level would allow the small to medium-sized dealers to profitably handle the small orders that large firms refuse by having high "minimums."

Statement of
Jennie S. Stathis, Associate Director
General Government Division

Before the
Subcommittee on Private Retirement Plans
and Oversight of the Internal Revenue Service
Senate Finance Committee

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist in your continuing review of the civil penalty provisions in the Internal Revenue Code (Code). At your request and that of the Subcommittee on Oversight, House Ways and Means Committee, we are reviewing IRS' administration of 11 key civil penalties and monitoring the Commissioner's Civil Penalty study. We have not completed our work; thus, the results we present today are preliminary.

The success of our tax system depends on voluntary taxpayer compliance. To encourage compliance and to punish noncompliance, Congress has enacted numerous civil penalties. In the past 70 years, nearly 150 such penalties have been placed in the Code. In many instances, penalties were enacted or modified on an ad hoc basis without full consideration being given to the overall structure.

In fiscal year 1987, IRS reportedly assessed almost 27 million penalties, totaling over $14 billion. This was more than a 100 percent increase over the total dollar amount of penalties reported in 1986.[1] With greater use of penalties, it is understandable that more questions have been raised about the role civil penalties should play in our tax system and about how IRS administers penalties.

My statement today is in three parts:

-- First, we discuss IRS' administration of civil penalties and what we know from prior reviews about existing problems.

-- Second, we address one aspect of penalty administration--the information available to managers.

-- Third, we comment on the IRS Commissioner's Study of Civil Penalties, its usefulness and its limitations.

IRS PENALTY ADMINISTRATION

Like other aspects of tax administration, taxpayers can encounter many different penalty situations, not only because of the large number of penalties but also because IRS' civil penalty management is so decentralized. Penalties are assessed and abated by various functional areas within IRS such as Examination, Returns Processing, Collection, and Employee Plans/Exempt Organizations. The process involves thousands of IRS employees in 10 IRS service centers and 63 district offices all across the nation. Thus, IRS has a great challenge to ensure that the penalties are consistently administered.

The potential for inconsistency is exacerbated by the complexity of the penalty assessment and abatement process. IRS assesses penalties by computer and manually. Computer assessments typically involve the taxpayer failing to take a required action by a specific date such as failure to file a return or pay taxes on time. The computer is programmed to look for specific situations such as these and to assess the appropriate penalty when warranted.

Manual assessments are usually more complex and require more judgment. They involve such penalties as negligence, fraud, and understating tax liability. IRS employees may either "propose" or "assess" one of these penalties at the completion of an audit. If a penalty is proposed, the taxpayer receives advance notice and has an opportunity to prove that the penalty should not be assessed. On the other hand, when a penalty is not first proposed, but immediately assessed, the taxpayer does not get this opportunity. Under either procedure, IRS sends a notice to the taxpayer explaining the penalty and providing information on appeal procedures.

IRS has the authority to abate certain penalties for reasonable cause or the taxpayer's due diligence. Upon reviewing the taxpayer's written statement, which is to fully explain the basis for a reasonable cause or due diligence abatement, IRS notifies the taxpayer of its decision. The penalty may be abated in whole or part or the abatement denied. If denied, or abated in part, the taxpayer is to receive information on further appeal rights. Depending on the Code section of a penalty, the taxpayer is given instructions on how to timely appeal within IRS or the Tax Court or how to petition the U.S. District Court.

Each IRS district office has a Penalty Review Committee to assure that penalty assessments and abatements are fair, fully documented and clearly applicable. The committees periodically review a limited number of assessments and abatements.

Problems Identified in IRS Administration of Penalties

Our current review is too preliminary to have conclusions on IRS' effectiveness in administering an increasingly complex system of civil penalties. However, our past work on several specific penalties and recent reports by the IRS Internal Audit staff identified problems which should be considered in a comprehensive review of the civil penalty structure. These include instances where penalties were not assessed when warranted, where penalties were not computed accurately, and where IRS District Office policies varied on the assessment of certain penalties.

Penalties Not Assessed When Warranted

Both IRS Internal Audit and GAO studies have shown that IRS did not assess penalties in all cases where they were warranted.

Some examples:

-- IRS Internal Audit concluded that, in 1986, IRS overlooked $437 million of penalties that should have been assessed against employers who claimed fictitious tax deposits on their employment tax returns.

-- Our study of IRS' administration of the penalty for promoting abusive tax shelters showed that IRS did not assess all applicable penalties in 39 percent of 28 cases three offices closed between September 1982 and July 1986. District officials did not know that multiple acts of organizing, promoting, and selling abusive tax shelters by the same person were each subject to penalty.

-- This month, we reported that IRS has no way to determine whether payors of interest and dividends comply with the requirements of the Taxpayer Identification Number Penalty Program.

Penalties Not Computed Accurately

Computation and other types of errors have also been documented. In 1987, IRS' Internal Audit found computation errors in 27 percent of 75 selected examination cases. These cases covered examinations of 1983 and 1984 individual income tax returns in 5 districts and one service center. The calculation errors ranged from an overassessment of $1,386 to an underassessment of $259.

In our tax shelter promoter study, we found computation and oversight errors in the assessment of abusive tax shelter promoter penalties. IRS made 20 such errors resulting in about $4.0 million in penalty underassessments in 31 percent of the 29 total cases at 3 district offices.

Inconsistent District Office Enforcement Policies

Inconsistent enforcement of penalties by IRS district offices has also been identified as a problem. For example, in 1983 we reported that each IRS district determined its own level of activity for assessing the return preparer penalty against preparers who endorsed or negotiated taxpayers' refund checks. One district office, which took a more vigorous approach to identifying such situations and assessing the penalty, accounted for 75 percent of these penalties assessed nationwide during 1981.

IRS' 1987 statistics indicate that wide variations still exist. The number of return preparer penalty assessments per district ranged from zero to 341. Even larger variations occurred in terms of the dollar value of assessments. Of the total $4.3 million in such penalties assessed, $2.2 million were assessed in a single district. Abatements also varied and were not in proportion to the number of assessments.

A second example is our study of IRS' administration in three districts of the tax shelter registration late or non-filing penalty. We found that one district decided not to administer the penalty because of a belief that it was too new. The other districts were assessing late filing penalties but were using a late filing grace period greater than that established by the National Office.

In 1985, IRS Internal Auditors found that IRS offices inconsistently administered the substantial understatement of tax liability penalty. Specifically, some but not all service centers used the penalty on correspondence examinations; some offices used the penalty when taxpayers did not appear for their appointments or provide records requested by the examiner but others did not; and some offices used the penalty concurrently with other penalties but others did not.

CONCERNS WITH PENALTY INFORMATION

In addition to the problems discussed above, IRS' penalty administration is far more difficult because of the lack of good readily available information. We continue to have concerns about the quality of data available to IRS managers to oversee the work and to evaluate performance. Our concerns center on three issues:

-- whether IRS captures all of the data needed to provide management oversight of the penalty program,

-- why the information collected by IRS is not routinely made available to IRS management, and

-- whether the data IRS collects is accurate.

IRS data systems currently do not provide the information necessary to answer such basic questions as how many of each penalty are assessed and abated. They also do not capture information on penalties proposed but dropped before assessment, identify the reasons a penalty was assessed or abated, identify whether the penalty assessment or abatement was the result of an IRS or taxpayer error, or identify the IRS function which made the assessment or abatement. These information needs have been identified not only by GAO but also by IRS as long ago as 1979.

While a lot of information is not captured, data which is collected is not routinely made available to IRS management. In addition, IRS does not aggregate the collected penalty data to make it useful in reviewing the various issues and concerns associated with the imposition of civil penalties. This includes such issues as changes in the number and amount of penalties assessed, if penalties are being consistently assessed in the various district offices and service centers, and even if certain penalties are assessed at all. It is unclear how IRS is able to carry out its penalty management and oversight responsibilities without complete and accurate management information.

The quality of IRS' statistical data also needs to be improved. IRS Internal Audit concluded that penalty management information reports may contain misleading and inflated figures on assessments, abatements, and abatement rates. Internal Audit found that, in 1986, the statistics included about $340 million in Failure to Deposit employment tax penalties that had been erroneously assessed and subsequently abated. Because IRS detected and abated over 90 percent of these erroneous penalties before notifying taxpayers, including such figures in IRS statistics produced misleading results.

Our review of 1987 return preparer statistics indicated additional data accuracy problems. Preparer penalties under code section 6694 (a) and (b) are either $100 or $500 per assessment. However, IRS data shows that 16 districts have assessment totals that are not multiples of these amounts. For example, the total amount assessed in one district was reported as $64,809.

At this time we do not know the extent or cause of the data problems. Our ongoing penalty work will continue to address the data accuracy issue.

USEFULNESS OF THE COMMISSIONER'S STUDY WILL BE LIMITED

In the fall of 1987, the IRS Commissioner initiated a study of civil penalties to examine the value of penalties, identify administrative problems, and to recommend statutory and administrative improvements to the system. Given the ad hoc approach with which many of the present penalties were enacted, and the sweeping impact of the Tax Reform Act of 1986, the Commissioner's efforts are very timely. Based upon what we know about the study at this time, we believe it may be useful in reaching a consensus on the definition and role civil penalties should play in the federal tax system. However, we do not believe the study scope is comprehensive enough to

-- identify problems and the extent of problems in the current system,

-- determine the causes of problems and understand their impact, or

-- develop recommendations to correct specific problems or make broad changes in the system.

Study Focus Shifted to Norms of Conduct

Initially, the study task force focused much of its efforts on examining penalties in specific groupings. The penalties were grouped into six families--(1) failure to file/failure to pay, (2) understatement, (3) employee plans, (4)exempt organizations, (5) information reporting and (6) preparer/promoter.

Task force subgroups were organized to research and report on the penalties in these families. Reports from the subgroups were to provide information that could be used to develop the final report. It is our understanding that draft reports were prepared by each subgroup and transmitted to the Chairman of the Penalty Task Force earlier this year. However, according to the Task Force Chairman, the draft reports were of limited use because of the shift in focus and could not be used as planned. The Chairman is uncertain how the information in the reports will be used in the study's final report.

The Commissioner's Study will now address "norms of conduct." The norms of conduct are broken into four basic categories: (1) accuracy of returns, (2) timeliness of returns, (3) payment of liabilities, and (4) other specialized entities. We understand that the final report is expected to use these norms as a framework for categorizing the various civil penalties in the Code.

Limited Use of Empirical Information

The value of the study depends upon the quality and type of information or evidence it uses. In March 1988, we testified before the House Ways and Means Subcommittee on Oversight that the Commissioner's study would draw heavily on expert opinion and advice from IRS management and outside organizations. We also pointed out that the study's methodology did not provide for the scientific sampling of taxpayer returns and accounts needed to validate the nature and extent of perceived problems.

Our concern over the lack of empirical data and analysis has been increased by changes in the study methodology. The original methodology included the assembly of existing data on each of the penalties and the identification of any gaps in this data. As discussed above, we have concerns about the accuracy of IRS data. But at this time, we believe the data is sufficient to use as a starting point in identifying trends. We have requested such information, aggregated in various ways, which we plan to use in our review.

Discussions with the study's Executive Secretary and the Chairman of the Task Force indicate that even the limited data analysis originally proposed is no longer included in IRS' methodology. Without this data and additional empirical information, it will be difficult not only to verify whether perceived problems exist but also to quantify the extent of existing problems.

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[1] The increase partially reflects penalty information added to the data base in 1987 rather than an actual increase in penalties.

COMMUNICATIONS

Seidel, Inc.
BOX 60950
SAN ANGELO, TEXAS 76906

COMMITTEE ON FINANCE
United States Senate
205 Dirksen Building
Washington, D.C. 20510

Re: Pryor Subcommittee Hearing On Penalty Reform

Dear Sirs,

My family has been active in the construction business in West Texas for over 40 years and has managed to maintain a profitability that allowed our firm to stay current on tax payments until the second quarter of 1986. Then, during the rest of 1986 and part of 1987, we fell behind on our filing and payment of 941 taxes and were only able to again pay current 941 taxes beginning with the second quarter of 1987. Since that date, we have remained current and have paid off all of the trust portion of the delinquent 1986 and 1987 taxes. However, while struggling to pay off a $170,000.00 trust balance, the interest and penalty amounts that accrued are now almost equal to the initial tax liability owed.

We understand that the intent of the interest and penalty structure is to influence a business to obtain alternate funds at a lower interest rate and use these funds to retire federal tax liabilities as fast as possible. However, this intent must be balanced and limited by the consideration of feasibility. That is, can a business retire initial tax liability, interest and penalty out of future profits? Our experience with the present system has shown that the high interest and penalty rates presently in force are not realistically matched with potential profit margins. This situation presses business owners into viewing their positions as hopeless.

Therefore, we are requesting that this subcommittee recommend interest and penalty rate structures that are reasonable when compared with rates utilized by institutions involved in lending funds to businesses. We appreciate this opportunity to express our views as enlightened by first hand experience.

Respectfully submitted,

Daniel Seidel

Daniel Seidel, V.P.
915-658-6505

Comments

of

TAX EXECUTIVES INSTITUTE, INC.

on

"A Philosophy of Civil Tax Penalties" Prepared by the Executive Task Force for the Commissioner's Penalty Study

August 31, 1988

On June 8, 1988, the Internal Revenue Service released for public comment discussion draft entitled "A Philosophy of Civil Tax Penalties" which had bee prepared by the Executive Task Force for the Commissioner's Penalty Study. I the transmittal letter, the chair of the Executive Task Force wrote tha arriving at a consensus concerning "the philosophy and criteria that penaltie should conform to is paramount in determining whether deficiencies exist in th current structure or administration of penalties."

Tax Executives Institute agrees that in order to achieve a penalty framewor that is "fairer, simpler, and easier to administer," the first step is to develo a consensus on what the proper role of penalties should be in the tax system. W commend the IRS Task Force seeking to establish a credible framework for furthe consideration of the penalty area. We pledge to cooperate in this effort especially as it relates to the business tax community.

In this regard, on April 5, 1988, TEI filed a position paper with the IRS i which we offered our preliminary thoughts on the proper philosophical basis fo civil tax penalties. That submission, which also contained our recommendation concerning the structure and administration of the penalty system,[1] anticipate the issuance of the Task Force's Report when it asserted that "the philosophical, or (if you will) moral, basis for the imposition of penalties" had to b identified if the inquiry was to be successful.

In the comments that follow, TEI offers its reactions to the report of the IRS Task Force.[2] Specifically, we discuss the extent to which we believe the Institute's views on the philosophical tenets that must underlie the penalty system are consistent not only with those of the IRS Task Force but also with those set forth in the July 28, 1988, report of the Section of Taxation of the American Bar Association.[3] By discussing the similarities among the three reports as well as their differences, we hope to contribute to the emergence of a consensus for the development of a rational penalty system. We also discuss why adherence to uniform principles of fairness and simplicity mandates that many of the Internal Revenue Code's civil penalty provisions should be substantially modified or repealed outright.

I. Background

Tax Executives Institute approaches the subject of the Code's penalty provisions from a vantage point different from those of other organizations of tax professionals. We represent the corporate tax community and are only tangentially involved with individual tax rules and penalties. The Institute's 4,300 members are employed by the 2,000 largest corporations in North America and are charged with the day-to-day management of their companies' tax departments. Most of our members are certified public accountants or attorneys, or both.

TEI represents a cross-section of the business community, and is dedicated to the development and implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. As a professional organization, we are firmly committed to maintaining a tax system that works -- one that is both administrable and with which taxpayers can comply.

II. Definition of a Civil Tax Penalty

The IRS Task Force defined the term penalty as "an adverse consequence imposed on a person for failure to comply with a federal tax rule." (Page 3.) As far as it goes, this proffered definition is unassailable: clearly, a penalty should not be imposed unless the taxpayer fails to comply with a federal tax rule. The definition, however, may be misconstrued to suggest that -- in applying the Code's penalty provisions -- there are only two types of taxpayers: compliant and noncompliant.

Although such a bifurcation has obvious appeal, we submit it accords insufficient weight to the level of uncertainty that currently exists with respect to what the existing "federal tax rules" are. It is for this reason that TEI argued in its April submission that civil tax penalties --

> "should be exacted only for deviation from a clearly defined standard of conduct that is timely established and promulgated, either by Congress or the Treasury Department and Internal Revenue Service."

Stated differently, TEI believes that the Task Force's definition should be revised to take into account that the substantive tax rules are not always well known and, consequently, compliance or noncompliance is not always the choice that confronts the taxpayer. We agree that penalties, which are imposed for violating substantive rules, must be viewed separately from the substantive rules themselves. We suggest, however, that before a penalty assertion can be justified, the pertinent federal tax rule must be known or at least "knowable" (*i.e.*, subject to reasonable interpretation by a prudent person).[4]

We submit, moreover, that this issue is fundamentally one of definition (rather than administration). That is to say, the operative definition should give weight to the concept of culpability. The definitional act -- the somewhat facile division of the world into "good" (compliant) and "bad" (noncompliant) taxpayers -- should not sanction the imposition of penalties where the underlying law is unclear.[5] As the ABA Report suggests, the inquiry should be whether a taxpayer is at fault for not knowing what the law is. (ABA Report, at page 34.)

III. The Purposes of Civil Tax Penalties

In our April comments, TEI stated that penalties should have a single goal -- to encourage compliance by punishing voluntary, as distinct from inadvertent, deviations from the prescribed and existing (*i.e.*, clearly identified) standard of conduct. From this conclusion, we drew two corollaries: first, penalties should not be enacted or increased on a retroactive basis; and second, penalties themselves should never be enacted as a source of revenue. As we stated in our April comments, "retroactive or revenue-inspired penalties place in jeopardy the moral support for both the penalty scheme and our entire self-assessment system."

We also recommended in our April comments that the following three principles should mark all penalty provisions:

First, penalty provisions should be known and understandable to both taxpayers and the IRS.

Second, a penalty's severity should be appropriate to the taxpayer's culpability.

Third, the circumstances in which a penalty will *not* be asserted, even in the *face* of the taxpayer's failure to abide by the *prescribed* standard of conduct, should be identified.

These principles were implicitly embraced by the subsequently released ABA Report, which concluded (at pages 12-15) that the following legal criteria should govern the adoption, interpretation, and application of penalties:

1. A penalty should reflect its limited force in preventing undesirable behavior. Penalties are not the only means to prevent conduct that threatens harm to the tax system.

2. A penalty should reflect minimum standards, not ideal conduct. A penalty that imposes too high a standard will inevitably draw into question its own legitimacy by subjecting a broad segment of taxpayers to punishment.

3. A penalty should establish a certain and not imprecise standard to give a fair warning of what is actually required.

4. A penalty statute should give an independent and reasonably complete warning of the prohibited conduct. The occasion on which a sanction is to be imposed should be reasonably free from doubt.

5. The same misconduct should not be subject to more than one penalty.

6. A penalty should serve an educational function for the affected taxpayer and taxpayers in general.

7. The punishment imposed by a penalty should correspond with the seriousness of the threat to the tax system created by the conduct involved.

TEI is pleased that the IRS Task Force has embraced principles similar to those espoused by TEI in its April comments (as well as by the ABA in its report). Specifically, the Task Force concluded that "the sole purpose of civil tax penalties should be to enhance voluntary compliance."[6] (Page 7.) In reaching this conclusion, the Task Force expressly rejected revenue raising as a proper purpose of penalties, as well as the use of penalties as a means of punishing noncompliant behavior or of reimbursing the government for the cost of its compliance program. (Page 6.)

We commend the IRS Task Force for recognizing the limits of civil tax penalties as a compliance tool. We specifically embrace the statement in the Task Force's Report that "[i]f the taxpayer is ignorant of his or her obligations and this ignorance is not the result of a failure to pay adequate attention to his affairs, imposing a penalty probably does not serve a goal of specific deterrence." (Page 8.) Thus, both penalties and the underlying substantive law must be known and understandable to the taxpayer and the IRS before noncompliance can be justifiably punished.[7]

We also believe that any evaluation of the penalty system must take into account that penalties are only one of the tools that the IRS has at its disposal to encourage compliance with the tax laws. (Page 9.) Thus, due weight should be given to the other "weapons" in the IRS's compliance "arsenal." Perhaps most important are the IRS's educational efforts, which should be directed at ensuring that the substantive tax rules -- the expected standard of behavior -- are known. In addition, the development and implementation of effective examination and collection programs should not be overlooked in an effort to rationalize the injudicious enactment or assertion of penalties.

With particular regard to corporate taxpayers, the Coordinated Examination Program (CEP), which subjects certain corporate taxpayers to perpetual audit, has proven to be an effective and cost-efficient way for the IRS to deal with the complexity and resulting uncertainty that this group of taxpayers confronts on an annual basis. We would hope that one of the assumptions underlying the CEP program is that the role of TEI members and other corporate tax professionals is not to direct corporations to be noncompliant; rather, it is to minimize a corporation's tax liability, as well as its tax compliance cost, while complying with the law.

In other words, the CEP program -- even though generating substantial revenues for the IRS -- is not premised on the affected taxpayer's being intentionally noncompliant or acting in bad faith. Thus, the program acknowledges that taxpayers may -- in the words of the IRS Task Force's Report-- have "an acceptable reason for failure" (page 9) and that --

> "the appropriate enhancement of compliance may be the removal of the barrier [to compliance] rather than punishment of the noncompliant behavior." (Page 9.)

We submit that the indiscriminate wielding of the penalties sword in respect of these taxpayers -- without adequate regard for whether the applicable standard of conduct is discernible -- is not only unfair and counterproductive but also inconsistent with the stated purpose of the penalties system -- encouraging voluntary compliance.

IV. The Criteria for Evaluating Specific Penalties

From its discussion of the purposes and limitations of penalties, the IRS Task Force's Report proceeds to address the evaluation of particular penalties. Specifically, the Task Force concluded that penalties should be judged on the basis of their fairness, simplicity, administrability, and effectiveness. (Page 9.) TEI agrees that the four criteria developed by the Task Force are relevant in evaluating particular penalties. We offer the following comments with respect to each criterion.

A. Fairness. TEI is especially heartened by the Task Force's articulation of three distinct components of the fairness criterion: culpability, equity, and severity. In particular, we agree with the Task Force that --

o the quality of the taxpayer's intent in not complying should be taken into account and that taxpayer who, though noncompliant, is not compliant through "excusable ignorance" or other "excusable cause," should be penalized only if the general deterrence purpose of the penalty is sufficiently compelling (page 10); and

o a penalty for conduct that is sure to be discovered should not be as severe as a penalty for noncompliant conduct that is likely not to be discovered (page 11).

B. Simplicity. As to the simplicity criterion, TEI obviously agrees that both the substantive tax rules and applicable penalties must be "understandable and understood." (Page 11.) We similarly agree that simplicity may mean different things to different groups of taxpayers.

We must take issue, however, with the implication that corporations may properly be held to a higher standard of conduct than other taxpayers. Concededly, "[t]he practitioner or the sophisticated financial institution may be able to deal with more complexity than can many individual taxpayers." (Page 11.) Nevertheless, the substantive tax laws that corporations must contend with are exceedingly more complex than those applicable to individuals. For example, no matter how complex the individual tax rules might seem (even taking into account the passive activity loss rules), that complexity pales in comparison with the foreign tax credit separate limitation and interest allocation rules.

C. Administrability. The Task Force's Report states that "[p]enalties should be administrable and administered with reasonableness, responsiveness, and reproducibility." (Page 11.) The report continues to state that "when a rule could result in an inconsistent assertion or nonassertion [of the penalty] in a particular situation, the written rule should permit the administrator to take appropriate action." (Page 12.) The ominous implication of the statement is that in such cases the penalty should be levied.

TEI agrees that penalties should achieve reasonable results and that the concept of uniformity is certainly a meritorious one. We submit, however, that in exercising its discretion under the penalty provisions, the IRS should properly be disposed in such cases not to assert the penalty. Thus, if the literal application of the written rules would result in the non-assertion of a penalty, in no event should a taxpayer be subject to the penalty based on an administrator's judgment of what might be "appropriate." Conversely, where the taxpayer has made a good faith effort to comply (as determined under a facts-and-circumstances test), the penalty should be waived even though its assertion might be rationalized under a literal reading of the statutory provision.[8]

D. Effectiveness. As to judging the effectiveness of penalties, TEI believes it is appropriate to assert progressively more onerous penalties for continued failures to comply if such failures relate to a particular deduction, particular income item, or to a particular information reporting requirement. In this regard, we believe the Task Force's proposed "tracking system," pursuant to which a taxpayer would be minimally penalized for the initial instance of noncompliance but subject to stiffer penalties for ongoing noncompliance, merits consideration. Stiffer penalties should not be asserted, however, simply because the taxpayer was noncompliant for more than one tax period when the later infraction is not directly related to the first.

The Task Force concluded its discussion of the applicable criteria by stating that a proper analysis of the four standards should be approached on "an issue-by-issue, penalty-by-penalty basis and temptations to simplify or paint with a broad brush should be carefully considered, if not avoided entirely." (Page 13.) TEI disagrees that compliance should be approached on a targeted basis, and submits that the Task Force's proposed approach could be used to justify a further proliferation of the number and type of penalties. We suggest that the judicious application of a limited number of properly drawn penalties (such as a revised negligence penalty) to all areas of the tax law could effectively meet the four criteria listed above.

V. The Goals for Administering Penalties

The Task Force concluded that "the goals of administering the penalties have been inadequately developed." (Page 15.) In an effort to address this shortcoming, the Task Force suggested that penalties should be imposed, contested, and resolved in a manner that is responsive, reasonable and reproducible. (Page 11, 15-16.)

With respect to the goal of "reproducibility," the Task Force stated that "a particular set of facts should give rise to the same outcome, regardless of what office or individual makes the final decision." (Page 15.) TEI agrees in principle, but believes that the penalties system should lend itself to the resolution of penalty issues at the audit level. Specifically, we recommend that the IRS's Penalty Screening Committees (PSCs) should be utilized in the manner discussed in our April submission.[9] We do not believe CEP taxpayers should be forced to go to the Appeals Division to "negotiate" a proposed penalty. Nor should the Appeals Division have the authority to initially raise a proposed penalty with a taxpayer. Thus, if the examining agent in a CEP audit does not assert a penalty, the Appeals Officer should not be permitted to use the penalty as a perceived "bargaining chip."[10]

VI. Discussion of Specific Penalties

Part VII of the Task Force's Report is devoted to a discussion of six major penalty groups: (i) understatement, (ii) failure to file and failure to pay, (iii) information returns, (iv) preparer, promoter, and protester, (v) exempt organization, and (vi) employee plans.

The Task Force has done a generally commendable job of identifying the major issues that need to be addressed in respect of each of these categories of penalties. We suggest, however, that in framing the issues, the Task Force frequently deviated from the philosophy and goals set forth in the first six parts of its report. Stated simply, although suggesting (albeit tentatively) certain amelioratory changes to some penalty provisions, part VII of the Task Force's Report seemingly embraces penalties that deviate from the principles that should underlie a rational penalty system.

In the comments that follow, TEI offers its reactions to the Task Force's comments on specific penalty categories. For simplicity's sake, our views generally follow the organization of the Task Force's Report.[11]

A. *Negligence and Fraud Penalties*. In its April comments, TEI argued that there should be no penalty in the absence of negligence or fraud -- that is, where the taxpayer does not engage in any proscribed conduct. We recommended, however, that the penalties for negligence and fraud should be refined and toughened, and the definitions of culpable conduct (negligence and fraud) should be clarified, either by statute or in implementing regulations.

We specifically urged that the level of the negligence penalty be substantially increased, but further recommended that the penalty should be based simply on an appropriately determined percentage of the amount of any deficiency attributable to negligence (not on the entire underpayment). Adoption of this latter recommendation would harmonize the negligence and fraud penalties and prevent situations where the assertion of a fraud penalty would result in a lower penalty than would the assertion of a negligence penalty. We also recommended that the penalty interest provisions be repealed.[12]

TEI is pleased that the IRS Task Force has recommended that consideration be given to (i) whether the interest component of the negligence penalty should be repealed; (ii) whether the negligence penalty should be targeted; and (iii) whether the rate of the negligence penalty should be increased. (Page 19.) The IRS's adoption of TEI's recommendations in this regard would contribute to the development of a rational penalty system. The Task Force also concludes that the imposition of multiple penalties for a single instance of misconduct "seems unnecessary" (page 20) -- a conclusion TEI wholeheartedly supports. Accord ABA Report, at pages 38-39.

In this regard, we note that the ABA Report not only supports the repeal of the interest component of the negligence penalty (ABA Report, at page 39), but is also in accord with TEI's recommendation that the negligence penalty should be asserted solely with respect to the amount attributable to negligence, and not on the entire underpayment. (ABA Report, at pages 37-38.) In addition, TEI believes that the negligence penalty should not be imposed where the taxpayer discloses his position. For example, a taxpayer should not be penalized for intentionally disregarding rules and regulations where the taxpayer reasonably believes the regulation is not supported by the underlying statutory provision and that position is disclosed on the appropriate income tax return. Accord ABA Report, at page 35.

B. *Substantial Understatement Penalty*. As both our April comments and the preceding discussion make clear, TEI is very much concerned about the theoretical basis for, and the application of, the substantial understatement penalty imposed by section 6661 of the Code. We have recommended that the provision be repealed, and are pleased that the ABA Report espouses a similar recommendation. (ABA Report, at pages 47-48.) Like the ABA, TEI believes that culpable taxpayer behavior can be adequately addressed by a refined negligence provision.[13]

Given our recommendation that section 6661 be repealed, TEI is understandably dismayed by the approach taken by the IRS Task Force toward the substantial understatement penalty. The Task Force properly frames the issue as "what behavior should be penalized" (page 16), but proceeds to suggest that the failure to disclose "aggressive positions" is behavior that should be defined as noncompliance and, hence, penalized.

TEI continues to believe that the substantial understatement penalty is flawed in concept and application. The principal question is, concededly, what behavior should be expected from taxpayers. Its answer: a good faith effort to comply with the tax laws. Consequently, taxpayers "who endeavor in good faith to fairly self-assess [should] not be penalized." H.R. Rep. No. 97-760, 97th Cong., 2d Sess. 575 (1982) (Conference Report on the Tax Equity and Fiscal Responsibility Act of 1982) (discussion of section 6661). As the ABA Report states, the penalty should "reflect minimum standards, not ideal conduct." (ABA Report, at page 12.) Hence, even though taxpayers should aspire to more than non-fraudulent, non-negligent behavior, they should not be penalized for not achieving the ideal -- the filing of a virtually "perfect" tax return.

TEI is also concerned about the disparate treatment potentially accorded equally compliant (or noncompliant) taxpayers under section 6661 because of the 10-percent threshold for application. Thus, if two taxpayers -- one with a substantial amount of taxable income and the second with a net operating loss -- misreport the identical item on their return (for the same "reasons"), only the second may be subject to the substantial understatement penalty since the amount of the item might not equal or exceed 10 percent of first taxpayer's income tax liability.[14] In view of the goal of fairness and its component "equity," we suggest that it might be appropriate to revisit, as an independent matter, the use of a percentage threshold in section 6661.

TEI also believes that proponents of section 6661 misapprehend how taxpayers (especially large corporate taxpayers such as those that TEI members represent) make return reporting decisions and how the substantial understatement penalty operates. Thus, the Task Force intimates that the penalty is asserted against taxpayers that consciously decide not to report "aggressive positions" -- those that choose to play the so-called audit lottery. For most CEP taxpayers, however, that is simply not the case. First, such taxpayers are under continual audit by the IRS and, accordingly, could not engage in the "audit lottery" even if they chose to. Perhaps more fundamentally, most of the section 6661 penalty situations with which TEI is familiar deal not with aggressive positions having been taken on the tax return, but rather with a multi-year and in-depth CEP audit uncovering facts that were unknown to the corporate tax department at the time the return was prepared.[15] Thus, the disclosure provisions afford no relief to CEP taxpayers in these situations.

As discussed in our April submission, TEI commends the IRS for adopting several of our recommendations concerning the scope of section 6661. For example, the development of Revenue Procedure 85-26, 1985-1 C.B. 580, concerning the application of the qualified amended return provisions of the section 6661 regulations to taxpayers who are subject to the coordinated examination (CEP) program, and the expansion of the "adequate disclosure" revenue procedure (currently, Revenue Procedure 88-37, 1988-30 I.R.B. 31) to include treatment of items disclosed on Schedule M-1.

If section 6661 is to be retained, however, further recognition should be given to the special scrutiny to which CEP taxpayers are subjected. In this regard, the Task Force implied that the severity of penalties is a function of the small likelihood of an audit. (Page 19.) With respect to CEP taxpayers, however, the likelihood of an audit is quite high -- 100 percent. Consequently, consideration should be given to amending section 6661 to include a provision such as the following (which we proffered several years ago):

> Section 6661(d). -- Provision for Regularly Examined Taxpayers.--With respect to a taxpayer that had, at the time the return referred to in subsection (b)(2)(A) was filed, at least 10 consecutive tax years examined by the Secretary and reasonably believed that the return being filed would also be examined, the standard of "reasonable basis" shall be substituted for the requirement of "substantial authority" in subsection (b)(2)(B)(i). For purposes of this subsection, the term "reasonable basis" shall include, without limitation, the treatment of an item by the taxpayer consistent with treatment found to be appropriate during a prior examination by the Secretary, absent a change in the applicable statute.[16]

Indeed, inasmuch as continually audited taxpayers cannot play the so-called audit lottery, we submit there is merit in the proposal to exclude such taxpayers from section 6661's reach altogether.

Even apart from a statutory change, we recommend that the IRS accord due weight to the enormous compliance burden faced by corporate taxpayers as well as to the manner in which corporate tax departments operate. Specifically, any determination of the taxpayer's reasonable belief (see page 18) should relate directly to the corporate tax department or, in the event outside tax advisers are used, to the management of the corporation who is in communication with such outside tax advisers. As then-Commissioner Egger assured TEI during the Institute's April 13, 1983, liaison meeting with senior National Office representatives:

> "[T]he substantial understatement penalty is not aimed at companies acting in good faith, . . . TEI members will encounter far less trouble with the provision than they might think.
>
> * * *
>
> ". . . [T]he burden imposed by section 6661 is great and . . . the corporate tax department must be able to rely on the company's internal controls. The issue . . . goes to the taxpayer's good faith. If a taxpayer follows its normal procedures but there is a 'glitch,' the penalty should not be imposed. In those cases, there should be a waiver."[17]

Thus, where the company has established reasonable controls and has made a good faith effort to comply, the tax department's lack of knowledge with respect to certain facts should not give rise to the substantial understatement penalty.

Finally, we recommend that, if the substantial understatement penalty is retained, the recommendations set forth in our April submission with respect to (i) the waiver of the penalty, (ii) the definition of substantial authority, and (iii) the scope of the adequate disclosure provision be adopted. We note that our recommendations generally accord with the alternatives set forth in the ABA Task Force. (ABA Report, at pages 49-51.)

C. *Information Return Penalties*. In recent years, the information reporting requirements imposed by the tax law have grown enormously. Because of the scope of these rules and the corresponding number of opportunities for inadvertent -- if not unavoidable -- noncompliance, TEI believes it is important for the attendant penalties for noncompliance to be reevaluated.

Specifically, TEI agrees with the IRS Task Force that information return penalties should not unduly burden third parties nor be a mechanism of first resort in achieving compliance. (Page 20.) More fundamentally, we agree that if the taxpayer has instituted reasonable business practices to assure compliance and has made a good faith effort to comply, then any otherwise applicable penalty should be waived. Where there is an intentional determination not to comply with a known reporting requirement, of course, the assertion of penalties would be appropriate.

We similarly endorse the Task Force's statement that the penalty system should educate payers to comply voluntarily and, consequently, that first-time offenders should generally be warned rather than penalized. (Page 20.) We note, however, that the policy of not penalizing taxpayers in such situations is not being uniformly honored in the field. In this regard, we recommend that consideration be given to issuing a revenue procedure on the assertion of information return penalties, a principal goal of which should be uniformity of treatment. *Accord* ABA Report, at pages 118-19.

D. *Estimated Tax Penalty*. TEI is very concerned about the Task Force's characterization of the Code's estimated tax penalties. Specifically, the Task Force's Report states that "[w]hile denominated penalties, these additions to tax are, in reality, interest." (Page 27.) The report rationalizes its conclusion, by noting:

> "Thus, when all is said and done and the taxpayer settles an account which includes this addition to the tax, the taxpayer merely pays to the Government the amount his or her funds earned at the time they should have been paid to the Government." (Page 27.)

The Task Force also intimates that corporations should be held to a higher standard than individuals with respect to estimated taxes, and suggests that the penalty might properly be increased since the high repeat rate shows that there are taxpayers who intentionally disregard the requirement. (Page 27.)

TEI submits that, regardless of how it is calculated, the estimated tax penalty is punitive in nature. (As Shakespeare might say, a penalty called another name would be deceit.) Nomenclature aside, we believe the Task Force's characterization of the penalty as a "mere" interest charge misses the point, which is that the overwhelming complexity of the tax laws makes it virtually impossible for corporations to accurately estimate their tax liability.

Contrary to the Task Force's bald assertion that taxpayers *intentionally* disregard the estimated tax rules, the barriers to compliance are almost insurmountable. There is no doubt that corporate taxpayers are aware of their obligation to pay estimated tax. In today's climate of rapid and far-reaching change, however, the calculation of the amount to be deposited remains an obstacle.[18] This is especially the case where one set of substantive rules has an undeniable rippling effect on myriad others.

Indeed, in the current environment, so-called large corporations are faced with the unenviable choice of either subjecting themselves to a penalty (under section 6655) for underestimating their liability *or* overpaying their taxes (in order to avoid the penalty). Concededly, if a corporate taxpayer's resources were unlimited and sufficient time were available, the precise estimation of its tax liability would be possible. Neither condition, however, is present. In this regard, we repeat our recommendation that --

(i) "large taxpayers" be permitted to base their estimated tax installments on their prior year's (or years') tax liability, *or*

(ii) the interest-on-overpayment provisions (section 6611(a)) be amended to pay interest to taxpayers that are effectively compelled to overpay their estimated taxes.

E. *Failure to Deposit Penalties*. The Task Force rightly characterized the operation of the penalty for failure to deposit taxes in a timely fashion as "draconian." (Page 28.) The penalty is not time sensitive and, thus, is the same without regard to how delinquent the taxpayer's deposit is.

TEI agrees that the level of the penalty should turn on how long the taxpayer's noncompliance continues (thereby providing an incentive to correct errors). Moreover, in light of the large number of failure-to-deposit penalties that are incorrectly asserted (and subsequently abated), we favor the adoption of a procedure whereby the penalty is not asserted automatically but rather the taxpayer is provided with an opportunity to explain why it should not be asserted. (*See* page 28.) Such a procedure would contribute to increased taxpayer confidence in the fairness of the system.

F. *Employee Plan Penalties*. There can be no serious doubt that the Task Force is correct in stating that the underlying law in respect of employee plans (including those relating to plan disqualification) is "exceedingly complex." (Page 30.) We also agree that the mechanical disqualification of pension plans for failure to comply with the Code's complicated provisions will harm rank-and-file workers. The specter of disqualification (as well as the assertion of applicable excise taxes and penalties for failure to comply with myriad disclosure and reporting requirements) could potentially discourage employers from maintaining such plans. (See page 30.)

We endorse the Task Force's call for the development of a less formidable system of sanctions to promote compliance with tax and labor laws relating to employee plans. Specifically, we support the proposition that targeted excise tax provisions can more properly and fairly effectuate the policies underlying the Code's employee benefit provisions. (We do recognize, however, that in extreme cases disqualification may remain an appropriate sanction.) We recommend, moreover, that in administering the employee plan provisions, due consideration should be given (as the Task Force states) to whether the taxpayer reasonably believed that the position he had taken was correct. (See page 18.) In this regard, we believe that good faith or *de minimis* errors should not place the entire plan in jeopardy.

VII. Conclusion

Tax Executives Institute appreciates the opportunity to present our views on the IRS Task Force's Report on civil tax penalties. We believe that much of the report merits support and look forward to working with the Task Force in crafting the administrative and legislative proposals necessary to develop a rational and equitable penalty system.

TEI would be pleased to respond to any questions the Task Force might have about our comments. In this regard, please do not hesitate to call Charles W. Rau, chair of TEI's Task Force on Penalties, at (202) 887-3249 or the Institute's professional staff (Timothy J. McCormally or Mary L. Fahey) at (202) 638-5601.

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[1] The recommendations encompassed both statutory and regulatory changes, as well as revisions to existing administrative procedures.

We would be pleased, upon request, to provide the IRS Task Force with additional copies of our April submission.

[2] For simplicity's sake, the Executive Task Force is referred to in these comments as "the IRS Task Force" or simply "the Task Force." Unless otherwise noted, page references are to the typewritten version of the report of the IRS Task Force.

[3] The report of the ABA Section of Taxation, which is captioned "Penalties Study Report," was prepared by a Penalties Task Force whose members were drawn from the Section's Committee on Civil and Criminal Penalties and its Committee on Administrative Practice. In these comments, the report is referred to as "ABA Report."

[4] Thus, where there are two or more reasonable interpretations of the statute, taxpayers should not be penalized for adopting the interpretation most favorable to the determination of their tax liability, even if -- ultimately -- that interpretation is not sustained as a matter of substantive law.

[5] In this regard, we endorse the statement in the Task Force's report that "[g]iven that the purpose of penalties is not to punish the noncompliant, the fact of noncompliance is an insufficient basis for the imposition of a penalty." (Page 8.) We recommend that this thought be incorporated into the definition of a legitimate penalty.

We also recommend that in assessing whether a taxpayer's noncompliance should be subject to a penalty, consideration should be given to how long the applicable substantive rule has been outstanding. Where the underlying substantive provision is recently enacted or where the IRS has not yet issued necessary guidance, penalties should be only sparingly imposed for noncompliance. This assumes, of course, that there is a need for such administrative guidance: where the statute is clear on its face, the taxpayer's noncompliance -- even within the "grace period" -- should not merit special treatment.

[6] The Task Force also stated that penalties serve to establish "norms of conduct." (Page 5.)

[7] As we stated in our April comments, all penalty provisions should be placed within a single chapter or subchapter of the Code, with cross-references to and from the substantive provisions where appropriate. The adoption of this recommendation would, by itself, enhance taxpayer and IRS understanding of penalties.

[8] This would be consistent with Blackstone's maxim, "It is better that ten guilty persons escape than one innocent suffer."

[9] For convenience sake, the portion of our April comments relating to the operation of PSCs (pages 25-28) is attached as an appendix to these comments.

[10] See ABA Report, at page 84 (expressing concern about the potential for abuse where the assertion of a penalty is threatened during negotiations with the IRS).

[11] Thus, the order in which we discuss the specific penalties should not be construed as indicative of their relative importance to the Institute.

[12] As we stated in our April comments, "the penalty interest provisions serve no compelling function other than increasing the amount of the penalty (which is accomplished much more easily by raising the level of the basic penalty); repeal of the penalty interest provisions will also make computation of the penalty easier."

[13] We agree with the ABA Report that section 6661 was "adopted by Congress based on an incomplete, inadequate or misconceived notion of the application of the negligence penalty and its suitability to deal with taxpayers who purportedly relied on advice from tax advisers." (ABA Report, at page 48.)

[14] Indeed, the same taxpayer could find itself on either side of the penalty threshold with respect to the same item, depending on yearly fluctuations of its total income, deductions, and credits.

[15] In our April comments, we listed several particular cases in which the substantial understatement penalty has been asserted --at least at the audit level. Those situations included cases where IRS personnel have --

- asserted a section 6661 penalty after the taxpayer discovered on audit that an error had been made in making a Schedule M-1 adjustment and disclosed it to the examiner (the taxpayer's perception being that, absent taxpayer disclosure, the agent would not have found the item); and
- informed a taxpayer that the preparation of tax returns on the assumption that the financial books of account of a publicly traded and independently audited company were accurate was not sufficient to merit a waiver of the penalty at the audit level.

[16] The adoption of a reasonable cause standard in such cases would be consistent with the Task Force's statement (at page 10) of "excusable cause."

[17] A more comprehensive quotation from the approved minutes of the 1983 liaison meeting is set forth in our April submission.

[18] The Task Force's report refers to the "high repeat rate" for the assertion of the estimated tax penalty, but offers no empirical data on the extent to which the "repeat offenders" are individual taxpayers, small corporate taxpayers, or "large corporations" (those that cannot avail themselves of the prior year's tax safe harbor).

Appendix:

Excerpt from TEI's April 5, 1988, Statement on the the Civil Penalty Provisions of the Internal Revenue Code

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2. Utilization of Penalty Screening Committee. Based on comments rece from a number of our members, TEI questions whether Penalty Screening Committ (PSCs) are functioning appropriately in all districts. For example, in cert districts members believe that PSCs are, in fact, not reviewing proposed sect 6661 assertions. In other districts, Penalty Screening Committees are percei as mere "rubber stamps" for proposed penalty assertions.

An additional question relates to whether PSCs should review only situatic where a penalty is proposed to be asserted or

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whether their role includes reviewing cases where the section's mathematic threshold is surpassed but the revenue agent (auditor) concludes that no penalt should be asserted. As a fundamental matter, TEI believes that the non-assertic of section 6661 penalties should not be reviewed by PSCs in order to avoi implied pressure to justify non-application or, more to the point, to assert th penalty in such cases. Routine quality control measures, however, would continu to be appropriate.

The stage during the audit at which a possible section 6661 penalty i forwarded to the PSC, as well as the development of the legal and factual facets of the automatic (by operation of statute) and discretionary waiver of the penalty, also seems to differ by district. To minimize confusion and facilitate the uniform application of National Office policy concerning the penalty, TEI recommends that the following procedure be implemented with respect to CEP audits in all districts.

- o At the point during the audit when the Coordinating Agent determines that the section 6661 dollar threshold may be crossed and the Coordinating Agent tentatively concludes that the penalty may apply, the taxpayer should be given an Information Document Request (IDR) (Form 4564) that affords the taxpayer an opportunity to provide its rationale (as well as supporting authorities) for why the penalty should not be asserted. The taxpayer should be given a reasonable amount of time (say, 30 days) to respond to the IDR.

- o Following receipt of the taxpayer's response to the IDR, the Coordinating Agent, with the

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approval of the Case Manager, should prepare a report to the PSC. A copy of the report should be provided to the taxpayer.

- o The taxpayer should be given up to 30 days to submit a written response to the Coordinating Agent/Case Manager's report, which should be forwarded to the PSC. (Ideally, the Coordinating Agent/Case Manager's report and the taxpayer's response should be simultaneously provided to the PSC.)

- o The PSC should make a decision whether the section 6661 penalty should be asserted. The Coordinating Agent/Case Manager, however, should retain authority not to assert the penalty, notwithstanding the PSC's decision.

Adoption of the foregoing procedure would standardize the handling of proposed section 6661 assessments in respect of all CEP taxpayers, thereby aiding uniformity of treatment. It would also permit more detailed development of the sometimes complex factual and legal questions attendant to a proposed CEP penalty at the audit stage and subject the matter to PSC scrutiny before the penalty is asserted by the IRS. Thus, adoption of the procedure would assure that issues relating to the possible existence of substantial authority, adequate disclosure, and the discretionary waiver of the penalty are more fully reviewed at the audit level. It would also permit a taxpayer to present its views on the applicability of the discretionary waiver to the PSC. Finally, it would avoid situations of possible intimidation of taxpayers by revenue agents or Appeals Officers using the section 6661 penalty as a lever to induce agreement from a taxpayer on a substantive issue that would otherwise be unjustified.

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We also suggest that it would be appropriate for the National Office to publish standards that would be utilized by all PSCs in applying section 6661 discretionary waivers. (See Item No. 6, "Development of a Penalties Revenue Procedure," below.)

PATTON, BOGGS & BLOW
2550 M STREET, N.W.
WASHINGTON, D.C. 20037

October 25, 1988

Honorable David Pryor
United States Senate
Washington, D.C. 20510

Re: Penalties Imposed Upon Payors of Reportable Interest and Dividends

Dear Senator Pryor:

This letter is submitted for inclusion in record of the hearings held on September 28, 1988 by the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service with respect to the Internal Revenue Code penalty structure.

I.

Summary of Statement

In August 1983, Congress enacted legislation to require payors of interest and dividends to obtain certified taxpayer identification numbers ("TINs") from payees and to impose backup withholding where no TIN or an incorrect TIN is obtained. If the payor reports an incorrect TIN to the Internal Revenue Service (the "IRS"), an annual penalty of $50 per account is imposed unless the payor exercised "due diligence" in trying to obtain a correct TIN from the payee. To meet the due diligence standard for then existing (pre-1984) accounts, payors were required by the IRS to make a separate mailing to all payees by December 31, 1983.

The Treasury and the IRS have taken the position that payors which missed the December 31, 1983 due diligence deadline, but came into full compliance after that date and before July 1, 1988, are nevertheless subject to the penalties (which can amount to millions of dollars annually) for all years prior to 1988. Thus, under this administrative interpretation, a payor which achieved full compliance (i.e., completed the separate mailing to all payees) in 1986 is nevertheless subject to these penalties for 1986 and 1987. This is unfair to the affected payors since no taxpayer should be subject to a penalty for any period from and after the date it is in full compliance. It is also unsound public policy since it will discourage taxpayers from complying with new requirements at the earliest possible date.

II.

Discussion and Analysis

A. Background.

The Interest and Dividend Tax Compliance Act of 1983 amended the Internal Revenue Code to require payors of reportable interest and dividends to obtain certified TINs from payees and to impose backup withholding where no TIN or an incorrect TIN was obtained. Under section 6676(b) of the Internal Revenue Code, an annual penalty of $50 per account, without limitation as to the total penalty, is imposed on payors who report an incorrect TIN to the IRS. An exception to this penalty is allowed for payors who have exercised "due diligence" in trying to obtain the correct TIN from a payee. For the reasons explained below, the due diligence requirement has been inappropriately applied by the IRS to penalize payors for periods when they are admittedly in full compliance with the law.

1. Separate Mailing Requirement. During the period October-December 1983, the IRS issued three sets of Temporary Regulations which interpreted the due diligence exception to require payors of interest and dividends to solicit certified TINs from all existing (i.e., pre-1984) accounts. These regulations generally required payors to make the initial solicitation by way of a separate mailing no later than December 31, 1983. Thereafter, payors were required to make annual follow-up solicitations which could be included in regular mailings of other materials to payees. Payors who have made the initial separate mailings and the follow-up mailings are considered by the IRS to have exercised the required due diligence.

2. IRS Enforcement Position. The IRS initially took the position that a payor who did not make the required initial separate mailing by December 31, 1983 was subject to the penalty under section 6676(b) for each account with a missing or incorrect TIN and that this penalty applied for each year after 1983 until the account was closed or a certified correct TIN was obtained. For this purpose, the IRS takes the position that when a payor obtained a certified TIN from a payee after December 31, 1983, the payor continued to be subject to the penalty if the certified information did not exactly match the information contained in the records of the Social Security Administration (e.g., the payee used a middle initial with the payor, but the Social Security Administration records showed a middle name).

Under this enforcement approach, a payor could not relieve itself of the original failure to make a timely separate mailing even if it (1) made the required separate mailing on an untimely basis, (2) made all required follow-up mailings, (3) obtained a certified (but "incorrect") TIN and (4) imposed backup withholding on any accounts for which there was an incorrect or missing TIN. Under this approach, large payors of interest and dividends (e.g., life insurance companies, banks, thrift institutions, credit unions, and brokerage houses) remained subject to penalties in the millions of dollars for each year after 1983 simply because they did not, for whatever reason, make the required separate mailing by December 31, 1983.

On October 21, 1987, the IRS announced that it would exercise its administrative discretion to permit payors who failed to make a timely separate mailing to relieve themselves of penalties for 1988 and subsequent years if a separate mailing for pre-1984 accounts was made during the limited time period beginning October 26, 1987 and ending December 31, 1987. The IRS also stated that no credit would be given for untimely separate mailings made between January 1, 1984 and October 25, 1987. (See IRS Notice 87-71.)

On November 23, 1987, the IRS modified this position to permit affected payors to relieve themselves of penalties by making the required separate mailing at anytime after December 31, 1983 and by June 30, 1988. However, the IRS continued to adhere to its original position that any such untimely mailing would be given effect to eliminate the penalty under section 6676(b) only for 1988 and subsequent years. (See IRS Notice 87-74.) This position was thereafter incorporated into Temporary Regulations on this subject. (Temp. Treas. Reg. § 35a.9999-1, Q&A-56.)

B. The IRS Position Must Be Reversed.

Under the IRS approach, a separate mailing made after 1983, regardless of when made, is only effective to eliminate penalties for 1988 and subsequent years. Thus, a mailing made in 1986 is effective to eliminate penalties in 1988 but is not effective to eliminate penalties in 1986 or 1987. For the following reasons, this enforcement position must be reversed:

- Congress Did Not Mandate Such An Approach. The applicable provisions of the Code do not themselves contain any specific deadline by which a payor must have solicited certified TINs for its pre-1984 accounts.

- The IRS Position Thwarts The Congressional Purpose. The legislation purpose underlying the TIN and certification and backup withholding provisions -- to require payors to exercise reasonable efforts to obtain certified TINs on their interest and dividend-paying accounts and, failing that for whatever reason, to collect and report backup withholding -- is best served by policies that encourage payors to solicit TINs as quickly as possible and not by extending their exposure to continuing penalties for an arbitrary period of time.

- The IRS Position Is Unfair. Payors who made separate mailings prior to the IRS' change in administrative position were acting in good faith and were attempting to perform their obligations in furtherance of the legislative purpose. They should not be penalized for so acting. The IRS position does precisely that by inequitably placing payors who made good faith, albeit late, efforts to solicit TINs on an equal footing with payors who completely disregarded their statutory obligations and the IRS' regulations.

- The IRS Position Is Bad Precedent. A failure in this instance to give effect to separate mailings until 1988 will discourage compliance efforts in the future for similar provisions.

III.

Proposed Solution

Payors who made the required separate mailing after the original December 31, 1983 deadline should be relieved from penalties under section 6676(b) for the year in which the mailing was made (provided the mailing was early enough to permit proper reporting by the payor for that year) and for all subsequent years (not just 1988 and future years).

Very truly yours,

PATTON, BOGGS & BLOW

By: Donald V. Moorehead